United Nations A/CN.9/WG.VI/WP.71/Add.6

General Assembly

Distr.: Limited
15 September 2016

Original: English

United Nations Commission on International Trade Law
Forty-ninth session
New York, 27 June-15 July 2016

Draft Guide to Enactment of the UNCITRAL Model Law on Secured Transactions

Note by the Secretariat

Addendum

Contents

V.16-05871 (E)

Chapter VIII. Conflict of laws

Introduction

1. Chapter VIII of the Model Law states the rules for determining the substantive law applicable to the issues dealt with in the other chapters. These rules are generally referred to as the conflict-of-laws rules. In a State that has enacted the Model Law, a court or other authority will use the conflict-of-laws rules of chapter VIII to determine which State's substantive law will govern issues such as the creation, effectiveness against third parties, priority and enforcement of a security right, as well as the mutual rights and obligations of the grantor and the secured creditor and the rights and obligations between third-party obligors and secured creditors. The substantive law indicated by the conflict-of-laws rules may be that of the enacting State or the law of another State. It must be noted that in the event of litigation in a State, a court or other authority in that State should apply: (a) the substantive law of its own legal system to characterize an issue for the purpose of selecting the appropriate conflict-of-laws rule; and (b) the conflict-of-laws rules of its own legal system to determine which State's law is applicable to the substance of the dispute (for a more elaborate discussion of the role of conflict-of-laws rules, see Secured Transactions Guide, chap. X, paras. 1-13).

2. The application of the conflict-of-laws rules relating to security rights in a particular case should not be conditional on a prior determination that the case presents an international element. Whenever a conflict-of-laws rule refers to the law of a State, that reference should not be refused on the ground of the absence of true "internationality" in the situation. Otherwise, courts might disregard a conflict-of-laws rule of a State by deciding that the case is not sufficiently international on the basis of discretionary criteria that are not part of the conflict-of-laws rules of that State. In other words, if in a given situation the rule of State A points to the law of State B, it must be presumed that the legislator of State A has considered that the situation of itself is presenting an international element. In the particular circumstances where additional criteria would be a prerequisite for the application of a conflict-of-laws rule of a State, these criteria should be spelled out in the conflict-of-laws rules of that State.

3. The conflict-of-laws rule dealing with the law applicable to the mutual rights and obligations of the parties points to the law governing the security agreement (see art. 84). It is not, however, a mandatory law rule (as it is not listed in art. 3, para. 1, as a mandatory law rule). The parties may choose the law applicable to their contractual rights and obligations and this is recognized by article 84. However, the conflict-of-laws rules dealing with the law applicable to the creation, third-party effectiveness, priority and enforcement of a security right, as well as with the effect of a security right on a third-party obligor, are mandatory (see art. 3, para. 1). Therefore, with respect to those matters, the parties cannot be permitted by a choice-of-law clause to avoid the substantive law provisions of the legal system to which a conflict-of-laws rule refers. This is because security rights are property (*in rem*) rights and thus affect third parties. Allowing the parties to a security agreement to select the applicable conflict-of-laws rule where the selection has third-party effects would also defeat one of the main purposes of the conflict-of-laws rules, which is to identify the State whose substantive law will apply in the event of a

priority dispute among competing claimants. For example, if there is a priority dispute between secured creditor X and secured creditor Y, it would be impossible for third parties to ascertain the law applicable to the resolution of the dispute if each of X and Y were permitted to choose in their security agreement a different governing law for the ranking of their respective security right.

A. General rules

Article 84. Mutual rights and obligations of the grantor and the secured creditor

4. Article 84 is based on recommendation 216 of the Secured Transactions Guide (see chap. X, para. 61). It states that the parties to a security agreement are free to choose the law applicable to their contractual relationship. Article 84 follows the approach recommended by international texts on this matter, including the Hague Principles on Choice of Law in International Contracts (the "Hague Principles"). The question of whether there should be constraints to party autonomy with respect to the law applicable to contractual relationships is not addressed in the Model Law and is left to other conflict-of-laws rules of the enacting State. These other rules will also determine the law governing the contractual relationship between the parties in the absence of a choice of law in the security agreement; these rules will often point to the law of the State most closely connected to the security agreement. It should be noted that the rule of article 84 is confined to the contractual aspects of the security agreement. As already mentioned (see para. 3 above), matters relating to the property aspects of secured transactions (e.g. the priority of a security right) are outside the scope of freedom of contract; the parties cannot select a law other than that indicated by the conflict-of-laws rules on such matters.

Article 85. Security rights in tangible assets

5. Article 85 is based on recommendations 203-207 of the Secured Transactions Guide (see chap. X, paras. 28-38). It deals with the law applicable to the creation, effectiveness against third parties and priority of a security right in a tangible asset. The term "tangible asset" is defined to refer generally to all types of tangible movable asset, including money, negotiable instruments, negotiable documents and certificated non-intermediated securities (see art. 2, subpara. (ll); see also Secured Transactions Guide, chap. X, para. 26).

6. Paragraph 1 states the general rule that the law applicable to these issues is the law of the State in which the encumbered asset is located (the "*lex situs*" or the "*lex rei sitae*"). Article 91 deals with the scenario where the location of the asset changes to another State after the security right has been created. The *lex situs* rule for tangible assets is subject to five exceptions that are set out in articles 85, paragraphs 2 to 4, 98 and 100.

7. The first exception provides that, if a tangible asset located in a State is covered by a negotiable document in the possession of a secured creditor in another State, the priority of the security right over the asset will be determined by the law of the State in which the document is located, and not by the law of the State in which the asset covered by that document is located (see art. 85, para. 2). Unlike recommendation 206, on which paragraph 2 is based, which referred to priority as

against “a competing security right”, to cover all priority conflicts (e.g. as against a judgment creditor), paragraph 2 refers to priority “as against the right of a competing claimant”. The second exception points to the law of the State in which the grantor is located for an asset of a type which may be ordinarily used in more than one State in the course of its normal use, that is, a “mobile asset” (see art. 85, para. 3; for the meaning of “location”, see art. 90; for the relevant time for determining location, see art. 91). The test is an objective one and does not refer to actual use. The most obvious example is an aircraft, which may fly from a State to many other States. The rule will apply even if a particular aircraft is actually operated only in one single State.

8. The third exception deals with a tangible asset (other than a mobile asset) in transit or to be exported (see art. 85, para. 4). A security right in a tangible asset located in a State which is in transit or destined to be moved to another State may be created and made effective against third parties under the law of the State of its ultimate destination, if the asset reaches that destination within the period of time to be specified by the enacting State. It should be noted that: (a) if the asset does not reach the intended destination in a timely fashion, the rule in paragraph 4 will not apply; and (b) under the rule in paragraph 1, a secured creditor may also take the necessary steps to create and make the security right effective against third parties under the law of the State in which the asset is actually located at the time such steps are taken. It should also be noted that paragraph 4 is a conflict-of-laws rule of the enacting State only and whether the security right will be treated as validly created and made effective against third parties in the State of the ultimate destination of the asset depends on the law applicable under the conflict-of-laws rules of that State.

9. The fourth exception is contained in article 100, which refers to laws other than the law of the State in which the certificate is located for a security right in certificated non-intermediated securities. The fifth exception is contained in article 98, which refers to the law of the State in which the grantor is located for third-party effectiveness by registration with respect to certain types of tangible asset where that law recognizes registration as a method for achieving third-party effectiveness for these types of asset.

10. Another possible exception was contemplated in the Secured Transactions Guide for assets, in respect of which a notice of a security right may be registered in a specialized title registry or noted on a title certificate. In the case of a security right in such an asset, the law applicable to the security right was proposed to be the law of the State under whose authority the registry is maintained or the certificate is located (see Secured Transactions Guide, chap. X, paras. 37 and 38, as well as rec. 205; see also A/CN.9/WG.VI/WP.71/Add.1, para. 85). This exception was not retained in chapter VIII.

Article 86. Security rights in intangible assets

11. Article 86 is based on recommendation 208 of the Secured Transactions Guide (see chap. X, paras. 39-47). It states the general conflict-of-laws rule for the creation, effectiveness against third parties and priority of a security right in an intangible asset (including a receivable). The applicable law is that of the State in which the grantor is located (for the meaning of “location”, see art. 90; for the

relevant time for determining location, see art. 91). This rule is subject to several exceptions.

12. The first exception relates to the priority of a security right in a receivable arising from a sale or lease of, or secured by, immovable property (see art. 87). The other exceptions relate to a security right in rights to payment of funds credited to a bank account (see art. 97), intellectual property (see art. 99, which refers both to the *lex protectionis* and to the law of the State of the grantor's location) and non-intermediated securities (see art. 100).

Article 87. Security rights in receivables relating to immovable property

13. Article 87 is based on recommendation 209 of the Secured Transactions Guide (see chap. X, para. 54). It deals with the priority of a security right in a receivable arising from a sale or lease of, or secured by, immovable property as against the rights of competing claimants. Article 87 is an exception to the general rule of article 86 and refers that matter to the law of the State under whose authority the immovable property registry is maintained. For article 87 to apply, the right of a competing claimant must be registrable (but not necessarily registered) in the relevant immovable property registry. It should be noted that, for a secured creditor to be able to determine the law applicable to the priority of its security right in these circumstances, it must be able to find out whether the receivable arises from a sale or lease of or is secured by immovable property.

Article 88. Enforcement of security rights

14. Article 88 is based on recommendation 218 of the Secured Transactions Guide (see chap. X, paras. 64-72). Subparagraph (a) deals with the law applicable to the enforcement of a security right in a tangible asset, as defined in article 2, subparagraph (ll). It refers to the law of the State in which the asset is located at the time of commencement of enforcement (*lex fori*). Subparagraph (a) is subject to an exception for certificated non-intermediated securities (see art. 100).

15. It should be noted that enforcement may involve several distinct actions (e.g. notice of the secured creditor's intent to obtain possession of an encumbered asset without applying to a court or other authority, disposition of an encumbered asset, and distribution of the proceeds of disposition) that may take place in different States. For example, a secured creditor may take possession of the encumbered assets in one State, dispose of them in a second State, and distribute the proceeds of disposition in a third State. A similar issue arises if a security right is created in several tangible assets that are located in different States or in a less frequent case where enforcement takes place in different States because the asset has been moved to another State after commencement of enforcement. In each case, the applicable law will be the law of the State of the location of the relevant asset at the time the first enforcement action is taken.

16. Under, subparagraph (b), the law applicable to the enforcement of a security right in an intangible asset (with the exception of a right to payment of funds credited to a bank account, intellectual property and uncertificated non-intermediated securities; see arts. 97, 99 and 100)) is the law governing priority. The main advantage of this approach is that the creation, third-party effectiveness, priority and enforcement of a security right in an intangible asset (but not the rights and

obligations between the debtor of the receivable and the secured creditor; see art. 96) are referred to one and the same law (see Secured Transactions Guide, chap. X, para. 69).

Article 89. Security rights in proceeds

17. Article 89 is based on recommendation 215 of the Secured Transactions Guide (see chap. X, paras. 55-60). The following example illustrates how article 89 operates. Assume that the original encumbered asset is inventory, which is subsequently sold, and the purchase price is paid by a funds transfer to a bank account. Under paragraph 1, the law applicable to the question of whether the secured creditor automatically acquires a security right in the right to payment of the funds credited to the bank account as proceeds of the original encumbered inventory will be the law of the location of the inventory at the time of the putative creation of the security right (see art. 91, para. 1 (a)). Under paragraph 2, the law applicable to the third-party effectiveness and priority of the security right in the proceeds will be the law that would be applicable to a security right in the right to payment of the funds credited to the bank account as an original encumbered asset (see art. 97).

18. It should be noted that this type of bifurcated rule may lead to difficulties in cases where the law governing creation recognizes a broad-based automatic proceeds rule whereas the law governing third-party effectiveness and priority recognizes no or only a very limited automatic proceeds right. It should also be noted that article 89 is dealing only with the law applicable to proceeds derived from the original encumbered assets as a result of a disposition by the grantor or other event prior to enforcement. Article 88 deals with the law applicable to the distribution of proceeds derived from a disposition of the encumbered assets pursuant to post-default enforcement proceedings.

Article 90. Meaning of “location” of the grantor

19. Article 90 is based on recommendation 219 of the Secured Transactions Guide (see chap. X, paras. 73 and 74). It should be noted that the State in which a grantor that is a legal person has its central administration is not necessarily the State in which that legal person has its statutory seat (or registered office). If the grantor is a legal person formed under the law of State A with its statutory seat in that State but has in State B a place of business where its senior management is based, then the grantor is located in State B. As a result of this approach, for example, the creation, third-party effectiveness, priority and enforcement of a security right in a receivable is referred to a single law that is generally easy to determine and is most likely to be the law of the State in which the main insolvency proceeding with respect to the grantor would take place, if the grantor were to become insolvent (in which case a secured creditor would most likely need to enforce its security right). Thus, this approach minimizes the risks of inconsistencies between the law governing the insolvency proceeding *(lex fori concursus*) and the substantive law applicable to a security right, as the two laws will be the law of one and the same State.

Article 91. Relevant time for determining location

20. Article 91 is based on recommendation 220 of the Secured Transactions Guide (see chap. X, paras. 75-78). It deals with the situation where the location of the asset

or the location of the grantor changes from one State (State A) to another (State B) in circumstances where the applicable law is determined by reference to that location.

21. Paragraph 1 establishes that the creation of a security right remains governed by the law of the location of the asset or of the grantor at the time of the putative creation of the security right even if there is subsequently a change of location. State B will recognize the existence of the security right if the latter was validly created under the law of State A at the time the asset or the grantor was located in State A. However, for third-party effectiveness and priority issues, the applicable law will be that of the actual location of the asset or the grantor "at the time the issue arises". This is the time of the occurrence of the event which triggers the inquiry as to what law would be applicable to third-party effectiveness or priority. For example, if an insolvency proceeding commences in State B in respect of the grantor of a security right in a receivable, the law applicable to the effectiveness of the security right will be the law of State B if the location of the grantor is then in State B (see art. 86).

22. As a result, for the security right to be treated as being effective against the insolvency representative either in State A or in State B, the third-party effectiveness requirements of the law of State B must have been fulfilled prior to the commencement of the insolvency proceeding. Another example is where a tangible asset is seized by a judgment creditor. The respective priorities of the secured creditor and the judgment creditor will be determined under the law of the location of the asset at the time of the seizure (which will be "the time the issue arises"). This is so in each example even if the security right had been made effective against third parties under the law of State A at the time the asset or the grantor was located in State A.

23. Paragraph 2 constitutes an exception to the general rules of paragraph 1. In the event of a priority dispute between two security rights that have been made effective against third parties in the State of the initial location, the priority dispute will be resolved under the law of that State (State A in the example).

Article 92. Exclusion of *renvoi*

24. Article 92 is based on recommendation 221 of the Secured Transactions Guide (see chap. X, para. 14). Its purpose is to reject the doctrine of *renvoi* and provide greater certainty with respect to the applicable law by avoiding the complications arising from this doctrine. Under the doctrine of *renvoi*, when the conflict-of-laws rules of a State (State A) refer an issue to the law of a another State (State B), that law would include the conflict-of-laws rules of State B. If that were the case and the conflict-of-laws rules of State A refer the priority of a security right to the law of State B, the conflict-of-laws rules of State B may refer that issue to the law of yet another State (State C). In that case, a court in State A would need to resolve the priority dispute using the law of State C (and not the law of State B). This result, however, would create uncertainty as to the applicable law and be contrary to the expectations of the parties. For those reasons, article 92 excludes *renvoi* (for an exception, see art. 95).

Article 93. Overriding mandatory rules and public policy (*ordre public*)

25. Article 93, which is based on recommendation 222 of the Secured Transactions Guide (see chap. X, para. 79) and article 11 of the Hague Principles, states generally recognized principles of private international law.

26. To illustrate how the rules in paragraphs 1 and 3 will operate, assume that the law of the forum (State A) prohibits dealings in certain types of asset (such as an asset which is the proceeds of criminal activities or is the subject of international sanctions) and that the law of the State whose law is applicable under the provisions of this chapter (State B) does not contain such a prohibition. In such a case, a court in State A may refuse to recognize a security right created in such an asset under the law of State B even though the law of State B does not contain the same prohibition. However, to do so, the forum court (in State A) must conclude that the application of the foreign law (of State B) would be manifestly contrary to the public policy of State A.

27. Under paragraphs 2 and 4, the forum court (if it is allowed to do so under its law) may refuse to recognize a security right that has been validly created under the applicable law (even if the applicable law is the law of the forum itself), if the creation of the security right would be manifestly contrary to public policy of another State (e.g. a State that has a close connection with the situation). For example, a law firm located in the forum State (State A) may wish to assign receivables arising from its legal services and the law of State A allows this assignment. However, the client is located in another State (State B) and, for reasons of public policy (confidentiality of lawyer-client relationship), the law of State B prohibits the transfers by a law firm of its receivables arising from legal services. In this case, the law of State A may allow a court in State A to take the public policy of State B into account in determining whether the assignment is valid.

28. Paragraph 5 is intended to make clear that the rules in paragraphs 1-4 may also be relied upon by an arbitral tribunal, although, unlike a court, it does not operate as part of the judicial infrastructure of a specific legal system. Under paragraph 5, an arbitral tribunal may take into account the overriding mandatory provisions and policies, for example, of the place of arbitration, however identified, or of the place where enforcement of any award would be likely to take place. Paragraph 5 requires an arbitral tribunal to determine whether it is required or entitled to take into account public policy or overriding mandatory provisions of another law, having regard (in particular) to the agreement of the parties, the designated or deemed seat of the arbitration, any institutional rules applicable to the arbitration, and the potentially controlling influence of State courts applying local arbitration legislation (see commentary to article 11(5) of the Hague Principles).

29. Under paragraph 6, the forum State may not displace the provisions of the law applicable to third-party effectiveness and priority of a security right and apply its own third-party effectiveness and priority provisions or those provisions of another State. This approach is justified by the need to achieve certainty with respect to the law applicable to third-party effectiveness and priority. The same approach is followed in article 23, paragraph 2, article 30, paragraph 2, and article 31 of the Assignment Convention, as well as in article 11, paragraph 3, of the Hague Securities Convention.

Article 94. Impact of commencement of insolvency proceedings on the law applicable to a security right

30. Article 94 is based on recommendation 223 of the Secured Transactions Guide (see chap. X, paras. 80-82). Its purpose is to establish that an insolvency court in the enacting State must in principle respect the law applicable to security rights under its conflict-of-laws rules. However, nothing in article 94 restricts the application of the law of the State in which insolvency proceedings are commenced (*lex fori concursus*) to matters such as the avoidance of fraudulent or preferential transactions, a stay of enforcement rights of secured creditors, the ranking of claims and the distribution of proceeds in the grantor's insolvency.

Article 95. Multi-unit States

31. Article 95 is based on recommendations 224-227 of the Secured Transactions Guide (see chap. X, paras. 83-87) and partly on article 37, first sentence, of the Assignment Convention. Its purpose is to deal with the law applicable where the State whose law is applicable to an issue under the provisions of this chapter has two or more territorial units, each of which has its own substantive law, and possibly its own conflict-of-laws rules. In such a case, subparagraph (a) provides that a reference to the law of a multi-unit State is in principle a reference to the law applicable in the relevant unit to be determined under the provisions of this chapter. For example, in the case of a security right in a receivable created by a grantor located (in the sense of having its central administration) in territorial unit A, the law applicable to that security right is the law of territorial unit A (see arts. 86 and 90).

32. However, under subparagraph (b), if the internal conflict-of-law rules of the multi-unit State or, in the absence of such rules, of the territorial unit to which subparagraph (a) points, refer security rights to the law in force in another territorial unit of that State, the substantive law of that other unit will apply. In the above mentioned example, if territorial unit A has a conflict-of-laws rule under which the law applicable is the law of the grantor's location defined as the place of the grantor's statutory seat and that place is in territorial unit B, the substantive law of territorial unit B will apply, It should be noted that subparagraphs (a) and (b) are interpretative provisions and also apply where the forum State is the State whose law is applicable under the provisions of this chapter.

33. Thus, subparagraph (b) is indirectly an exception to the exclusion of the doctrine of *renvoi* (see art. 92) as it introduces internal "*renvoi*". The purpose of the exception is to ensure that, where the applicable law is that of a unit of a multi-unit State, a forum court outside that multi-unit State will apply the substantive law of the same unit as a forum court in that multi-unit State would do under its internal conflict-of-laws rules.

34. As a result, for example, where the conflict-of-laws rules of this chapter refer to the law of the location of the asset or the grantor, the forum court is required to examine the internal conflict-of-laws rules in effect in the territorial unit of the location of the grantor or the encumbered asset (under the provisions of this chapter). In this regard, the Assignment Convention allows a declaration by States as to the determination of the applicable priority rule as between various territorial units (see art. 37 of the Assignment Convention), but in this article there would be no declaration and the forum court would have to determine the applicable law

under the conflict-of-laws rules in effect in the multi-unit State or, in the absence of such rules, in the territorial unit to which subparagraph (a) will point.

B. Asset-specific rules

Article 96. Rights and obligations between third-party obligors and secured creditors

35. Article 96 is based on recommendation 217 of the Secured Transactions Guide (see chap. X, paras. 62 and 63) and article 29 of the Assignment Convention. Its purpose is twofold. First, the conflict-of-laws rules on the third-party effectiveness or enforcement of a security right do not apply to the effectiveness or enforcement of a security right against a debtor of a receivable, an obligor under a negotiable instrument or an issuer of a negotiable document; they are not considered "third parties" for the purposes of the rules on third-party effectiveness and priority of a security right, as they are not competing claimants. Second, the law applicable to these issues is the law governing the legal relationship between the grantor and the relevant debtor of the receivable, or the relevant obligor under the instrument or the issuer of the document; the same law also applies to the question of whether any of the latter may invoke that their agreement with the grantor prohibits or limits the grantor's right to create a security right in the relevant receivable, instrument or document. For example, in the case of a receivable arising from a sales contract, the law chosen by the seller/grantor and the debtor of the receivable will apply to the matters covered by article 96.

Article 97. Security rights in rights to payment of funds credited to a bank account

36. Article 97 is based on recommendation 210 of the Secured Transactions Guide (see chap. X, paras. 49-51). While a right to payment of funds credited to a bank account is in the generic sense a receivable of the customer against the deposit-taking institution, to avoid interfering with banking law and practices, article 97 departs from the general conflict-of-laws rule on the law applicable to intangible assets (see art. 86). Two options are offered to the enacting State for the law applicable to the creation, third-party effectiveness, priority and enforcement of a security right in a right to payment of funds credited to a bank account, as well as to the rights and obligations between the deposit-taking institution and the secured creditor.

37. Under option A, the applicable law is that of the State of the location of the branch (or office) of the deposit-taking institution with which the account is maintained. It should be noted that a branch (or office) of a deposit-taking institution may be considered as being located in a particular jurisdiction irrespective of whether the institution offers its services through physical offices or only through an online connection accessible electronically by customers. In this regard, it should be noted that a deposit-taking institution must generally have a physical presence or legal address in a jurisdiction in order to be allowed by the relevant regulatory authorities to receive deposits and maintain bank accounts in that jurisdiction.

38. Under option B, the applicable law is the law designated in the account agreement as governing the issues that are the subject of article 97 or, in the absence of a designation of a law for these issues, the law designated by the parties to the account agreement as the law governing that agreement. To be effective for conflict-of-laws purposes, a designation must refer to the law of a State in which the deposit-taking institution is regularly engaged in the business of receiving deposits and maintaining bank accounts. It should be noted that the State whose law is so designated may be different than the State in which the grantor's bank account is maintained.

39. If the applicable law cannot be determined as described in the preceding paragraph, option B provides for a series of rules along the lines of the default rules contained in article 5 of the Hague Securities Convention, which the enacting State may wish to insert in this article, if it decides to adopt option B of article 97.

Article 98. Third-party effectiveness of a security right in certain types of asset by registration

40. Article 98 is based on recommendation 211 of the Secured Transactions Guide (see chap. X, para. 34). This article is an exception to the conflict-of-laws rules on the third-party effectiveness of a security right in a negotiable instrument, negotiable document, right to payment of funds credited to a bank account or certificated non-intermediated security. Under articles 85, 97 and 100, the effectiveness against third parties of a security right in any of these assets is governed by the law of a State which may be different from the State of the location of the grantor. However, under article 98, if the State of the location of the grantor recognizes registration of a notice as a method of third-party effectiveness for a security right in the types of asset coved in article 98, then the law applicable to third-party effectiveness by registration is the law of the State in which the grantor is located.

41. Therefore, with respect to these types of asset, a secured creditor may rely on the law of the location of the grantor to make its security right effective against third parties by registration, even if for these types of asset the applicable law might be different under the other conflict-of-laws rules of this chapter. However, if the priority rules of the applicable law are based on the priority rules of the Model Law, achieving third-party effectiveness by registration would only yield a lower-ranking priority in the case of a priority conflict with a competing secured creditor who achieved third-party effectiveness, for example, by possession in the case of a negotiable instrument (see art. 46, para. 1), by the secured creditor becoming the account holder in the case of a right to payment of funds credited to a bank account (see art. 47, para. 1) or by possession in the case of a negotiable document or a certificated non-intermediated security (see arts. 49, para. 1, and 51, para. 1 respectively). However, the security right would have priority over the right of: (a) the grantor's insolvency representative or the mass of creditors; and (b) judgment creditors, if registration took place before a judgment creditor, for example, seized the encumbered assets.

Article 99. Security rights in intellectual property

42. Article 99 is based on recommendation 248 of the Intellectual Property Supplement (see paras. 284-337). The effect of paragraph 1 is the following. If

intellectual property is protected in a particular State, the law of that State will apply to the requirements to be met for the security right in that intellectual property to be considered as having been created, made effective against third parties and enjoying priority in that State. It should be noted that a security right in intellectual property may be granted by any person that has a right in the related intellectual property under the relevant intellectual property law. Therefore, the grantor may be an owner, a licensor or a licensee of the intellectual property to be encumbered.

43. Paragraph 2 provides for an alternative way to create and make effective against certain third parties a security right in intellectual property. Under paragraph 2, the secured creditor may also rely for these purposes on the law of the State in which the grantor is located. The principal benefit of paragraph 2 is that, if the security right has been made effective against the grantor's insolvency representative under the law of the State in which the grantor is located, an insolvency court in the enacting State will recognize the security right even if the third-party effectiveness requirements of all States in which the intellectual property is protected have not been fulfilled.

44. Paragraph 3 refers enforcement issues to the law of the State in which the grantor is located. This rule allows for the same law to be applied to all enforcement steps, even if they take place in different States, because it is unlikely that the grantor's location (in particular the place of its central administration) would change between any of those steps. In the rare case where there would be such a change, it is assumed that a court would refer to the law of the State in which the grantor is located at the time of commencement of the enforcement (see art. 88). It should be noted that the effectiveness of the security right against persons other than the grantor (e.g. the licensor of the intellectual property, if the grantor is a licensee) is outside the scope of this article.

Article 100. Security rights in non-intermediated securities

45. Article 100 introduces one general rule for equity securities and another for debt securities. It should be noted that none of these general rules draws a distinction between certificated and uncertificated, or between traded and non-traded, securities. For equity securities, paragraph 1 designates the law of the constitution of the issuer as the law applicable to all issues (i.e. the creation, third-party effectiveness, priority, enforcement and effectiveness against the issuer of a security right in these securities). This approach provides greater certainty in the determination of the applicable law as referring to one single law for all such issues avoids the difficulties that can arise in circumstances where there could be an overlap between some issues (e.g., enforcement and effectiveness against the issuer) that could result in the referring them to different laws.

46. The term "equity" is not defined in the Model Law but it should be understood as referring to participation rights in the capital of the issuer. For a corporation or a similar legal person, equity securities consist of the shares in its capital. Similarly, for an entity which is not a legal person under its constitutive law (such as a general or limited partnership in many States), equity securities should refer to the rights of the persons (e.g. the partners) who are entitled to receive upon the liquidation of the entity the residual value of its assets after payment of its liabilities.

47. The test of the distinction between equity and debt securities should be based on their characterization for the purposes of corporate law, and not accounting or other law. Thus, preferred shares should be considered as equity securities even if under accounting or other rules they are classified as liabilities. Likewise, subordinated debt securities (e.g. debt payable in insolvency only after satisfaction of obligations owing to certain creditors, such as lenders) should be treated as debt securities even if subordinated debt may be viewed as equity from the perspective of lenders extending other credit to the issuer.

48. The law of the constitution of the issuer is the law under which it has been formed. For a corporation, this is easy to ascertain; it is the law under which it has been incorporated. For a partnership, it should be the law under which the partnership has been created. In federal States where the issuer may be constituted either under a federal law or a law of one of its territorial units, the Model Law does not provide specific criteria on the determination of the territorial unit which will be considered as the issuer's law where the issuer's law is a federal law and the law on secured transactions is that of a territorial unit. However, under article 95, the internal conflict-of-laws rules of the federal State (or of the territorial unit which is the forum) should determine the territorial unit's law to be applicable to the issues falling under article 100 where all or some of these issues are not dealt with by the federal law of the constitution of the issuer.

49. For non-intermediated debt securities, paragraph 2 applies the law governing the securities to all issues (i.e. the creation, third-party effectiveness, priority, enforcement and effectiveness against the issuer of a security right in these securities). As already noted (see para. 45 above), greater certainty is achieved by designating one single applicable law for all such issues. The law governing the debt securities is the law selected by the parties as the law governing their contractual rights and obligations arising from the issuance of these securities. In the absence of such a choice of law (which would be extremely rare for debt securities), the forum will determine the applicable law under its own conflict-of-laws rules. The Model Law does not deal with the question of whether the parties may select a governing law which has no connection with the issuance of the securities. This matter is left to the conflict-of-law rules on contractual obligations of the forum State.

50. The term "debt securities" is not defined in the Model Law. The notion of debt is however well understood in most legal systems and denotes a payment obligation. In the context of debt securities, the obligation is generally to make payment of a sum of money. Bonds, debentures and promissory notes are debt securities, to the extent they come under the definition of securities in article 2, subparagraph (hh). The obligation of a borrower to a lender under a credit facility would not qualify as a debt security as it is not captured by that definition. Such an obligation is rather a receivable and is subject to the conflict-of-laws rules on receivables.

51. The concept of "debt securities" raises the following two questions: (a) the characterization of convertible debt securities; and (b) the effect of that characterization on the law applicable to a security right in that type of security. Convertible debt securities are debt securities that are convertible into equity securities at the option of their holder or issuer or upon the occurrence of a specified event.

52. Convertible debt securities should be characterized as debt securities because they constitute payment obligations as long as they are not converted into equity. This means that upon their issuance and until conversion, the law governing these securities will be the law applicable to the creation, third-party effectiveness, priority, enforcement and effectiveness against the issuer of a security right in such securities. The characterization of convertible debt securities for the purposes of article 100 may, however, change if and once they are converted into equity. The connecting factor then becomes the law of the constitution of the issuer. Therefore, upon being converted into equity, the law applicable to a security right in convertible debt securities will be the law of the State under which the issuer has been constituted.

53. A consequence of the change from the law governing the securities to the issuer's law is that a security right in debt securities made effective against third parties under the law governing the securities might become ineffective against third parties after the change. Article 23 addresses the impact of a change in the applicable law and article 91 addresses a change in the connecting factor. However, strictly speaking, article 23 is not applicable to a change in the nature of non-intermediated securities; and article 91 only deals with the situation where the connecting factor is the location of the asset or the grantor. The enacting State may thus wish to draw from articles 23 and 91 and adopt rules dealing with the change on the basis of principles similar to those underlying articles 23 and 91.

54. Article 98 introduces an exception to the general conflict-of-laws rules of article 100. If the law of the State in which the grantor is located recognizes registration of a notice as a method for achieving effectiveness against third parties of a security right in certificated non-intermediated securities, the law of that State is also the law applicable to the third-party effectiveness of the security right in this type of asset by registration (see paras. 40 and 41 above). It should be noted that uncertificated non-intermediated securities are not mentioned in article 98 and, therefore, the issuer's law (and not the grantor's location law) is the law applicable to the third-party effectiveness by registration (if permitted by the issuer's law) of a security right in uncertificated securities.

Chapter IX. Transition

Introduction

55. This chapter accomplishes three tasks. First, it provides that the law formerly governing security rights (the "prior law") is repealed (see art. 101). Second, it provides rules governing the treatment of security rights that were created while the prior law was in force but continue to exist, perhaps for extensive periods of time, after the new secured transactions law (the "new law") enters into force (see arts. 102-106). Third, it sets a date on which the new law goes into effect (see art. 107). Thus, this chapter provides rules by which the law governing such security rights moves in a fair and efficient manner from the prior law to the new law (see Secured Transactions Guide, chap. XI, paras. 1-3).

Article 101. Amendment and repeal of other laws

56. The Model Law is intended as a complete system of secured transactions law, replacing in its entirety the prior law, rather than as a supplement to existing law. Accordingly, the enacting State should list in paragraph 1 and thus repeal the body of laws that comprise its secured transactions law. The way in which the repeal is effectuated will depend on the form of the prior law. Where the prior law is a free-standing code or the like, that code can be repealed in its entirety. Where the prior law is derived from statutes that also address other topics, though, the enacting State must determine how to excise the rules formerly governing security rights from the rules that apply to other topics. Where part of the prior law is based on judicial opinions (as may be the case, for example, in some common law systems), the method of repeal of the prior law must be determined by the enacting State.

57. Many other bodies of law interact with secured transactions law. In some cases, provisions of those other bodies of law may be based on the assumption that prior secured transactions law is in effect. Paragraph 2 provides the enacting State an opportunity to amend those provisions so as to mesh with the new law. It should be noted that, like any other article of the Model Law, article 101 can have effects only when the new law enacting the Model Law enters into force according to article 107. Thus, the existing laws are amended or repealed only as of the date the new law enters into force (in other words, there is no time in which neither set of rules governs secured transactions).

Article 102. General applicability of this Law

58. Paragraph 1 of this article defines two terms used in this chapter. According to paragraph 1 (a), “prior law” means the rules that applied to security rights under the law of the enacting State before the entry into force of the new law because, under the conflict-of-laws rules of the enacting State (as those rules existed before the entry into force of the new law), the applicable law may be the law of the enacting State or of another State, article 102 refers to the law formerly applicable under the conflict-of-laws rules of the enacting State. As a different law may be applicable to the various security right issues (e.g. the contractual rights and obligations between the grantor and the secured creditor, the creation, third-party effectiveness, priority and enforcement of a security right, as well as the effectiveness of the security right against a third-party obligor) prior law means the law formerly applicable to the relevant issue.

59. According to paragraph 1 (b), “prior security right” is a right created by an agreement entered into before the entry into force of the new law that the new law would treat as a security right within the scope of the new law. This is the case even if the agreement covers future assets (see art. 2, subpara. (n)). The transition provisions of the Model Law determine the extent to which, even after the entry into force of the new law, the rules of prior law continue to apply to a prior security right.

60. Paragraph 2, which is based on recommendation 228 (second sentence) of the Secured Transactions Guide (see chap. XI, paras. 7-12), states the general rule of the applicability of the new law. It provides that, when it enters into force under article 105, the new law will apply to all security rights within its scope, including prior security rights, except as otherwise provided in this chapter (e.g. arts. 103 and 104). Much of

the remainder of the chapter is devoted to providing exceptions to this general rule. Read together, the rule in paragraph 2 and the exceptions in the remainder of the chapter result in a transition period during which the new law will apply to all new transactions while some aspects of the rules of the prior law will continue to apply to some issues related to prior security rights.

61. As a result of paragraph 2, prior security rights may be governed, at least in part, by the new law. This is beneficial because, inasmuch as many secured transactions endure for several years, if the new law applied only to security rights created by agreements entered into after the effective date of the new law, the prior law would persist for a lengthy period during which lenders, borrowers, attorneys, and judges would need to be able to apply both the new law and the prior law (depending on the particular transaction) and during which searches for competing claimants would need to be done both under the rules of the new law and the prior law. Thus, a rule that the new law applied only to transactions entered into after its effective date would entail additional cost and delay the economic benefits of the new law.

Article 103. Applicability of prior law to matters that are the subject of proceedings commenced before the entry into force of this Law

62. Article 103 is based on recommendation 229 of the Secured Transactions Guide (see chap. XI, paras. 13-16). It introduces an exception to the rule in article 102, paragraph 2, that the new law applies to all security rights within its scope, including prior security rights. In particular, paragraph 1 provides that, if a matter with respect to a prior security right is the subject of litigation or arbitral proceedings commenced before the new law enters into force, the substantive (not procedural) law governing the dispute will remain the prior law (a forum may apply its own current rules of procedure when not inconsistent with those of the prior law). This paragraph applies to all disputes arising with respect to a prior security right, whether between the secured creditor and the grantor, the secured creditor and a competing claimant, or the secured creditor and a person liable, for example, on a receivable or negotiable instrument. It should be noted that the commencement of litigation before the new law enters into force with respect to one matter does not preclude the application of the rules of the new law to a separate matter arising under the same security agreement which is not the subject of litigation.

63. Paragraph 2 provides a substantive rule about the enforcement of security rights created under prior law. Under the rule in this paragraph, if enforcement is commenced under prior law (what constitutes “enforcement” and whether it was “commenced” are matters of prior law), the secured creditor may continue enforcement under the rules of the prior law even after the new law enters into force or, rather may choose to utilize the enforcement mechanisms of the new law (what constitutes “enforcement” under the new law enacting the Model Law is addressed in chapter VII). This rule applies even if the commencement of enforcement under prior law occurs without application to a court or other authority. Thus, for example, if before the entry into force of the new law the secured creditor takes actions authorized under prior law to obtain possession of an encumbered asset without applying to a court or other authority, the secured creditor may, after the entry into force of the new law, choose to dispose of the encumbered asset and distribute its proceeds under the prior law or proceed as to those matters under the new law.

Article 104. Applicability of prior law to the creation of a prior security right

64. Article 104 is based on recommendation 230 of the Secured Transactions Guide (see chap. XI, paras. 17-19). This article contains two rules. First, paragraph 1 provides that prior law determines whether a security right putatively created before the new law enters into force was indeed created effectively. Second, under paragraph 2, a prior security right that was effectively created under prior law will remain effective between the parties under the new law even if the requirements for creation under the new law have not been satisfied. This rule avoids the invalidation of prior security rights and the creation of a situation in which the secured creditor would need to obtain cooperation from the grantor to take the additional steps necessary to continue the existence of the security right under the new law. Such cooperation may not be forthcoming from a grantor that has already received an extension of credit secured by the security right in the encumbered asset.

65. For example, assume that before the new law entered into force: (a) prior law allowed the creation of a security right by means of an oral security agreement even in the absence of possession of the encumbered asset by the secured creditor; and (b) a secured creditor extended credit to a grantor and the grantor secured its repayment obligation by creating a security right in an intangible asset in favour of the secured creditor by means of an oral security agreement. In the absence of the rule in paragraph 2, the security right would not be effective between the parties under the new law and the secured creditor would need to obtain the cooperation of the grantor in order to have an effective security right because the new law requires a written security agreement signed by the grantor (see art. 6, para. 3).

Article 105. Transitional rules for determining the third-party effectiveness of a prior security right

66. Article 105 is based on recommendation 231 of the Secured Transactions Guide (see chap. XI, paras. 20-22). Under this article, a security right created and made effective against third parties under prior law before the effective date of the new law remains effective against third parties for a period of time under the new law, even if the conditions for third-party effectiveness under the new law have not been satisfied. The period expires at the earlier of the time when the third-party effectiveness of the security right would have ceased under prior law (see para. 1 (a)) or at the time specified in paragraph 1 (b).

67. Illustration: Under the prior secured transactions law of State X, a security right in a receivable could be made effective against third parties by notifying the debtor of the receivable, but the third-party effectiveness of the security right would cease after five years, unless the secured creditor sent a renewal notice to the debtor of the receivable (which would extend the third-party effectiveness of the security right for another five years. State X's enactment of the Model Law specifies three years as the time period for that rule in paragraph 1 (b)). One year before the new law entered into force, the grantor created in favour of the secured creditor a security right in a receivable owed to the grantor by the debtor, and the secured creditor notified the debtor of the security right. Under paragraph 1 (a), the security right would cease to be effective against third parties five years after the security agreement was entered into and notice was given to the debtor of the receivable under prior law (which, under these facts, would result in the security right ceasing to be effective against third parties four years after the new law entered into force).

Under paragraph 1 (b), the security right would cease to be effective against third parties three years after the new law entered into force. Thus, because the date in paragraph 1 (b) is earlier than the date in paragraph 1 (a), the security right will cease being effective against third parties under the new law three years after it enters into force (subject to the rules in paragraphs 2 and 3).

68. A security right that would cease to be effective against third-parties under the rule in paragraph 1 may continue to be effective against third parties if the secured creditor takes the appropriate steps under the new law to achieve third-party effectiveness. Most often, this result will be accomplished by registering a notice with the Registry. The secured creditor's ability to do so is aided by paragraph 4, which provides that the prior written agreement creating the security right constitutes sufficient authorization for registration of the notice.

69. Paragraphs 2 and 3 address the continuity of third-party effectiveness of a prior security right in situations in which: (a) a security right was effective against third parties under the prior law; and (b) the requirements for third-party effectiveness under the new law are satisfied. Paragraph 2 provides that, if the requirements for third-party effectiveness under the new law are satisfied before the expiration of the period specified in paragraph 1, the prior security right is continuously effective against third parties from the time when it was made effective against third parties; thus, the priority of that security right, for the purposes of the rules that determine priority by reference to the time of third-party effectiveness, will date from that time.

70. If, however, the requirements of the new law for third-party effectiveness of the prior security right are satisfied only after the expiration of the period specified in paragraph 1, there will be a gap between the expiration of third-party effectiveness under paragraph 1 and the achievement of third-party effectiveness under the new law. In that case, paragraph 3 provides that the security right is effective against third parties only from the time it is made effective against third parties under the new law; thus, the priority of that security right, for the purposes of the rules that determine priority by reference to the time of third-party effectiveness, will date only from that time.

71. The rule in paragraph 5 makes explicit a point that is implicit in paragraph 2. Paragraph 2 provides that, in cases in which the requirements for third-party effectiveness of a prior security right under the new law are satisfied before the expiration of the period specified in paragraph 1, the prior security right is continuously effective against third parties from the time when it was made effective against third parties under prior law. Paragraph 5 states that, in cases in which the security right was made effective against third parties by registration under prior law and the security right remains continuously effective against third parties under paragraph 2, priority rules that depend on the time of registration are to be applied using the time of registration under prior law.

Article 106. Application of prior law to the priority of a prior security right as against the rights of competing claimants arising under prior law

72. Article 106 provides an exception to the general rule in article 102, paragraph 2, that the new law applies to all security rights, including prior security rights. Under the circumstance described in article 106, the priority of a prior

security right as against competing claimants is determined by application of prior law.

73. In particular, under the rule stated in paragraph 1, the prior law, rather than the new law, determines the priority of a prior security right against competing claimants if that security right and the rights of all competing claimants arose before the entry into force of the new law and the "priority status" of competing claimants has not changed.

74. Paragraph 2 provides that the priority status of a security right has changed if either of the two events has occurred. First, the priority status has changed if: (a) the prior security right was effective against third parties under the new law only because of the rule in article 105, paragraph 1; and (b) third-party effectiveness ceased because the time period set out in article 105, paragraph 1 expired before the necessary actions occurred to make the security right effective against third parties under the new law. Second, the priority status of a security right has changed if it was not effective against third parties under the prior law at the time the new law entered into force but became effective against third parties when the new law entered into force or thereafter. The purpose of this rule is to preserve priority among completing claimants that was established under the prior law when no change has occurred other than the new law becoming effective.

Article 107. Entry into force of this Law

75. Article 107, which is based on recommendation 228 of the Secured Transactions Guide (see chap. XI, paras. 4-6), provides the date when or the mechanism according to which the new law will enter into force. The Model Law does not recommend a particular date or mechanism, and leaves that matter to the enacting State. The enacting State may wish to determine whether this article should be placed at the beginning or at the end of the new law.

76. In selecting a date or mechanism according to which the new law will enter into force, careful consideration should be given both to obtaining the economic benefits of the new law as soon as possible and to minimizing dislocations that may be caused by significant changes in secured transactions practice resulting from the new law. Inasmuch as the new law will have been chosen because it is an improvement over the prior law, the new law should come into force as soon as is practical. However, some lead time is necessary in order to, inter alia: (a) publicize the existence of the new law; (b) enable establishment of the Registry (or adaptation of an existing registry to the registry system required by the new law); and (c) educate participants in the secured transactions system, particularly present and future secured creditors, about the effect of the new law and the transition from the prior to the new law and enable them to prepare, for example, for compliance with new rules and use of new forms. For example, the new law may enter into force on a specific date or a few months after a specific date, or on the date to be specified by a decree once the Registry becomes operational.