by letters of credit would be relevant to first demand guarantees.

13. The programme of work of the Commission specifies that stand-by letters of credit be studied in conjunction with the International Chamber of Commerce (ICC). The issue of stand-by letters of credit was raised by the Secretariat at a meeting of ICC held on 6 April 1978 for the purpose of co-ordinating the work of ICC and that of the Commission. At that meeting, the Secretariat submitted a background paper on some of the issues raised by stand-by letters of credit, and in particular whether such credits would be governed by the ICC Uniform Customs and Practice for Documentary Credits or by the ICC Uniform Rules for Contract Guarantees. On that occasion ICC agreed to submit these issues to its Commission on Banking Technique and Practice. This Commission held a meeting, at which the Secretariat was represented, on 1 December 1978, and decided to establish a Working Party to study the problems connected with stand-by letters of credit.[16]

14. The Working Party held a meeting, at which the Secretariat was represented, on 29 March 1979, and decided to issue a detailed questionnaire as to the practice relating to stand-by letters of credit, and the difficulties encountered in their use.

15. In view of the fact that ICC has issued rules to govern commercial letters of credit and contract guarantees, the Commission might wish to decide that ICC be encouraged to continue its current work on stand-by letters of credit, and that the Secretariat be instructed to co-operate closely with ICC and report the progress of work to the Commission. It is suggested that the Commission should request ICC to submit the results of its work for consideration by the Commission before final adoption.

[16] ICC document No. 470/342.

C. Report of the Secretary-General: security interests; feasibility of uniform rules to be used in the financing of trade (A/CN.9/165)*

Introduction

1. At its eighth session the Commission requested the Secretary-General "to continue the feasibility study on the possible scope and content of uniform rules on security interests in goods, and for this purpose, to consult with international trade organizations and trade and financing institutions", and to submit a report on the subject at its tenth session.[1]

2. In compliance with that request the Secretary-General submitted to the tenth session of the Commission a study on security interests, based on the study prepared at the request of the Secretary-General by Professor Ulrich Drobnig of the Max-Planck Institut für Ausländisches und Internationales Privatrecht (Max Planck Institute for Foreign and Private International Law of the Federal Republic of Germany) (A/CN.9/131),** a study on security interests in the United States of America, note by the Secretariat on article 9 of the Uniform Commercial Code (A/CN.9/132),*** and a report of the Secretary-General on security interests (A/CN.9/130).

3. The Commission considered these reports at its tenth session. Although some representatives expressed the view that in light of the practical difficulties in establishing a scheme of uniform rules, the chances of a successful outcome of the work would be slight, the Commission "was generally agreed that in view of the practical importance of security interests to international trade, the secretariat should be requested to continue work on the subject".[2]

4. After an exchange of views on the feasibility of establishing uniform rules,[3] the Commission focused on three possible methods of harmonization:

(*a*) Preparation of rules of conflict of laws;

(*b*) Creation of substantive rules that would apply only to international transactions; and

(*c*) Unification of the national laws on security interests by means of a uniform law applicable both to national and to international transactions.

5. The discussions in the Commission revealed that there was little support for preparing rules on conflict of laws, and only some for creating an additional security interest that would be used primarily in international transactions but could also be used domestically. On the other hand there was considerable support for further study of the third method, i.e. the preparation of uniform rules, based on a functional approach, that would provide a basis for the unification of the national laws and would apply to domestic as well as international transactions.

6. Therefore, the Commission requested the Secretary-General:

"(*a*) To submit to the Commission at its twelfth session a further report on the feasibility of uniform rules on security interests and on their possible content, taking into account the comments and suggestions made in the Commission;

"(*b*) To carry out further work on the subject in consultation with interested international organizations and banking and trade institutions, and in particular to ascertain the practical need and relevance of an international security interest for international trade."[4]

* 17 May 1979.

** Yearbook . . . 1977, part two, II, A.

*** *Ibid.*, part two, II, B.

[1] UNCITRAL, report on the eighth session (A/10017), para. 63 (Yearbook . . . 1975, part one, II, A).

[2] UNCITRAL, report on the tenth session (A/32/17), annex II, para. 10 (Yearbook . . . 1977, part one, II, A).

[3] The report of the discussion in Committee of the Whole II is to be found in *ibid.*, annex II, paras. 9 to 15.

[4] A/32/17, para. 37.

7. This report is submitted in conformity with that request.

I. Security interests and commercial credit

8. In order to evaluate the practical need and relevance of uniform rules for security interests, it is necessary to examine the role of security interests in a credit system, whether that role is fulfilled under the current rules, and whether action by UNCITRAL could be useful to improve the situation.

Role of security interests in a credit system

9. A seller of goods or a financing institution which contemplates the extension of credit must be concerned with the possibility that the debtor will not repay the amount due at the stipulated date. Any risk in this regard increases the interest rate which the creditor would otherwise charge. If that risk is too great, the creditor will refuse to extend the credit requested. Therefore, it is to the advantage of both the debtor and the creditor to have means available to reduce the creditor's risk.

10. One of the most generally available means to reduce the creditor's risk is to arrange for some form of security upon which he can call in place of or in addition to the obligation of the debtor. Such forms of security can be classified under two types, first, a promise of a third party that it will pay the obligation of the debtor under certain circumstances and, secondly, a security interest in specified movable or immovable goods of the debtor.

Promises of third parties

11. Promises of third parties come in many forms. The third party may become a party to or guarantee the primary obligation by such means as a contract guarantee or an endorsement or *aval* on a negotiable instrument. In other cases the third party has no formal connexion with the underlying obligation but promises to pay the creditor if the debtor does not, or if he does not for certain specified reasons. One example of this type of third party promise is export credit insurance. In still other cases it is the third party who is expected to pay the creditor without any resort by the creditor against the debtor. Such is the case, for example, with the documentary letter of credit.

12. The promise of the third party to pay reduces the creditor's risk to the extent that the third party is solvent, has a reputation for discharging its obligations promptly, and is amenable to legal action in case of dispute. For these reasons the third parties who make promises of this nature in connexion with commercial obligations are usually large financial organizations such as banks or insurance companies and are typically doing business in the country of the creditor.

13. The third party may be able to make the promise to pay the underlying obligation, thereby reducing the creditor's risk of non-payment, without incurring any substantial risk of its own. For example, a bank which issues a letter of credit on behalf of a buyer with which it has a long standing relationship may run no substantial credit risk whereas the buyer's credit may be completely unknown to the seller-beneficiary of the credit. However, in many cases the third party is exposed to the same credit risk as the creditor would have been.

14. Nevertheless, the third party may be willing to run this risk in order to encourage the creditor to extend credit to the debtor. This is a common experience with small corporations where the owners of the equity of the company, who may be shielded from the debts of the company by virtue of its incorporation, are required to guarantee the obligations of the company before a bank will extend it credit. This may also be the case with some government sponsored export insurance where the primary purpose of the insurer's promise may be to promote exports.

15. However, in most cases of commercial credit the reason the third party is willing to make its promise is that it charges a fee sufficient to make a profit after paying administrative costs and providing for the risk that it will be called on to pay in place of the debtor. Where the risk is low, the fee is low. Where the risk is higher, the fee is higher.

16. One important way to reduce the third party's risk is for the third party to take a security interest in the debtor's goods. In the ideal case the third party would be automatically reimbursed through the security interest if the debtor did not reimburse him as required by the contract. This is almost the case with the documentary letter of credit where, if the buyer does not reimburse the bank, the bank can reimburse itself in whole or in part by enforcing its security interest in the documents and, through the documents, in the goods. In other transactions the security interest which the third party can take may not be so closely connected with the transaction for which the third party promise is given. However, the better the security interest which the third party can secure, the less its risk. The smaller the risk to the third party, the more likely it will facilitate the extension of credit to the debtor by promising to pay the creditor under the agreed conditions and the lower the fee it is likely to charge for making this promise.

17. Third party promises in the form of contract guarantees, export credit insurance, letters of credit and the like are an important form of security which facilitates the extension of credit for both domestic and international trade. In the international sphere the law in respect of certain types of third party promises has already been unified.[5] However, third party promises do not necessarily furnish the best or the least expensive form of security in all commercial situations, whether domestic or international. Furthermore, even when a form of third party promise is the fundamental security for an extension of credit, as has been discussed above, it may be supplemented by a security interest in the property of the debtor.

[5] E.g. Uniform Customs and Practice for Documentary Credits (International Chamber of Commerce, publication No. 290), reprinted in Yearbook ... 1975, part two, II, 3.

Security interests in goods

18. While a security interest can be taken in any form of property, this report will not consider security interests in immovables.[6]

19. The function of a security interest, like that of a third party promise, is to decrease the risk to the secured creditor that it will not be reimbursed the amount owed by the debtor. To the extent that a security interest reduces the risk to the secured creditor, it increases the likelihood that the secured creditor will be willing to extend credit to the debtor and it decreases the cost of that credit.

20. A security interest decreases the risk by providing that the secured creditor will have a right to realize the value of specific items of property owned by the debtor (the "collateral") ahead of other creditors of the debtor. Therefore, the secured creditor can be assured that, to the extent of the value of the collateral and to the extent that the law affords a procedure whereby that value can be realized by the secured creditor in case of non-payment by the debtor, the credit risk has been reduced.

21. Nevertheless, in spite of the obvious usefulness of security interests to stimulate the extension of credit, in many countries the law is such that security interests are of little use in respect of domestic commercial credit and of even less use where the secured creditor is in a foreign country or where the collateral may move from one State to another. In order to increase the usefulness of security interests, extensive revisions of the law have been proposed in some countries. The conclusion reached by the Banking Laws Committee of the Government of India was that:

> "In order to quicken the pace of implementation of the new economic programme of the Government aimed to maximize employment and yield optimum socio-economic benefits, the necessity is obvious for a statutory scheme which will take care of all the existing defects in our personal property security law."[7]

Defects in the current law

22. The defects in the current law in India as outlined in great detail in the report of the Banking Law Committee are illustrative of the situation in many countries, both developed and developing. The most pervasive problem is that of the existence of a number of different statutes governing different aspects of the law of security interests. These statutes have been adopted at different times to solve specific problems and have, at best, been only partially co-ordinated with one another. As a result there are conflicts in provisions, gaps in coverage, and confusion for business and financial circles, lawyers and the courts.

23. Furthermore, since these statutes were adopted to solve specific problems, even within their sphere of application they often leave unsolved problems which were not of major importance at the time of their adoption but which are today. Having for the most part been adopted prior to the Second World War, they are not well suited to the current patterns of trade and financing.

24. In general, it can be said that in most countries the law of security interests has developed out of one or more of three different sources. Most, if not all, countries recognize a possessory security interest.[8] In addition, some countries have developed a non-possessory security interest modelled on the mortgage of land. Finally, some countries have recognized a security interest growing out of the retention of title by an unpaid seller.

25. All three of these forms of security interest are of limited use for securing commercial credit. In particular, none of them is well designed for financing the acquisition of an inventory of goods held for sale or of an inventory of goods in the process of manufacture. Nevertheless, for many businesses the prime need for capital is the acquisition of inventory and the major asset which they would have to secure their obligations would be that inventory.

26. Typically, the procedures for realizing the value of the collateral in case of default by the debtor are slow and expensive and they do not encourage the sale of the collateral at prices similar to those that would be received at a commercial sale of similar goods.

27. The priorities between the secured creditor and other classes of claimants to the debtor's assets are often obscure. In case of the debtor's insolvency the secured creditor may discover that the collateral will be used to pay other obligations of the debtor or that extended litigation is necessary to establish its priority over other creditors in respect of the collateral.

28. All such defects in the law reduce the potential value of security interests to the creditor. It cannot be demonstrated in a verifiable manner that this loss of security has adverse economic effects, since it may be the case that credit is extended as willingly without a modern law of security interests as it would be with one. However, the experience of countries like India suggests that a modern law of security interests has the effect of providing sources of capital which would otherwise not be available, a matter of particular interest to the developing countries.[9]

II. Possible courses of action

Desirability of action by the Commission

29. Even if it is accepted that modernization of the law of security interests would be desirable, the question

[6] For the purposes of this report, immovables are restricted to land and buildings attached thereto. It is not necessary at this stage to consider under what conditions building materials or machinery might become immovables or under what conditions timber, crops or minerals in place might become movables.

[7] Report on Personal Property Security Law 1977, para. 1.2.4.

[8] The possessory security interest has usually been extended to include symbolic possession by the creditor of the collateral by control of those documents of title which are necessary in order to take physical possession of the collateral itself, such as ocean bills of lading, some other transport documents and in some cases warehouse receipts and the like.

[9] Report on Personal Property Security Law 1977, para. 1.2.4.

remains whether it would be desirable for the Commission to undertake action in this field. The arguments in favour are twofold.

30. First, many countries which might wish to modernize their law of security interests would welcome the aid which the Commission could give by furnishing them with a model text adapted to present commercial requirements.

31. Secondly, so long as the law of security interests differs significantly in different countries, the legal problems which arise when goods subject to a non-possessory security interest are moved from one State to another are difficult to solve satisfactorily. It is obviously undesirable if the receiving State refuses to recognize the security interest created abroad. However, it is equally undesirable if the foreign creditor has rights not available to a domestic creditor or if the foreign creditor was not required to give the same degree of publicity to the existence of the security interest as would a domestic creditor. Nevertheless, under the current situation a court must often choose one or the other of these two undesirable results.

32. In order to alleviate this situation, the law must be sufficiently similar in the State where the security interest was originally created and the State where it would be enforced so that the rights of the debtor, creditor and third parties would not be seriously affected by the movement of the goods. Once this has been accomplished, it would be possible to devise rules of conflict of laws which would make it possible to enforce a security interest in a State other than that in which it was created without upsetting the expectations of other claimants against the debtor.

Harmonization or unification

33. It is thought that, in order to achieve most of the desired benefits from unifying the law of security interests, it is not necessary to achieve identity of text. Instead, a basic scheme could be devised with suggested alternatives for provisions which present particular difficulties. States which wished to reform this aspect of their law regarding credit, and particularly States which wished to harmonize their law with that of other States so as to facilitate credit transactions between those States, would have a model from which to begin. Naturally, the more a State diverged from the model, the less it would be in harmony with other States which conformed to the model and the less it would secure the benefits of unification or harmonization of the law. Nevertheless, if use of the model, even with derogations to meet local conditions, served to improve the credit system in a State and served to harmonize the law amongst States, it would have served a useful purpose.

34. The preparation of a model law might be carried out in close collaboration with appropriate regional organizations, such as the European Communities or regional development banks. To the extent that the problems faced by different countries in the development of the law of security interests arise out of differences in economic development, appropriate regional organizations would be able to furnish the necessary expertise. Furthermore, if there were to be alternative versions of various provisions, it would be desirable that these variations be as uniform as possible between the principal trading partners and between States in the same stages of economic development.

Model law

35. The preparation of a model law would be a new working method for the Commission. To date the Commission has prepared three draft conventions and one set of model arbitration rules to be adopted by agreement of the parties.

36. Among the advantages to the use of a convention as the method of unification of law is the relatively greater likelihood that a State will not deviate from the agreed upon text when it adopts the convention by ratification or acceptance. This is of particular importance when the agreed upon text embodies a compromise in which the participants have given up positions of importance so as to achieve a common result. It is also important when the technical operation of the text requires uniformity in all jurisdictions in which it might be applied.

37. In other cases, however, it is not so important that the law be identical in every respect. Indeed, it may be obvious that the search for complete uniformity would hinder any movement towards unification. In such a case the existence of a model on which actual adoptions can be based may facilitate later decisions to use the model either as drafted or with modifications.

38. In the case of security interests, absolute uniformity on a world-wide basis is not now feasible. Therefore, the preparation of a model law for adoption by States with such modifications as they may deem desirable would be a proper method and could be expected to aid the development of a domestic credit system and to further the use of security interests in international trade as an alternative method of financing.

39. In those regions of the world, such as Western Europe, where there is a significant movement of goods subject to a security interest, there may be more need for the text as adopted in the different States to approach absolute uniformity. In such regions, there could be agreement amongst the interested States to adopt a uniform text, whether that text was the model law as proposed by the Commission or a new text based upon the model law.

III. Possible content of rules

40. At its tenth session the Commission requested the Secretary-General to consider in the report to be submitted to its twelfth session the possible content of uniform rules on security interests.[10] This portion of the report is submitted in conformity with that request.

[10] Para. 6 *supra*.

Form of security agreements

41. The uniform rules would have to indicate the form necessary for a security agreement to be enforceable by the creditor against the debtor. Other rules might govern the enforceability of the security agreement against third parties such as good faith purchasers of the goods or other creditors.

42. There are several possible approaches which could be taken to the required form of the security agreement:

(*a*) All security agreements might be required to be in writing and legally authenticated by a notary or a designated public official.

(*b*) All security agreements might be required to be in writing, but not to be authenticated.

(*c*) A security agreement might not be required to be in writing if there were other indicia of its existence, such as the transfer of possession of the collateral to the creditor.

(*d*) No security agreement might be required to be in writing.

In addition, it would be possible to provide that some security agreements had to be in writing and authenticated even if alternative (*b*), (*c*) or (*d*) was chosen as the basic rule.

Required and permissible provisions in the security agreement

43. Whether the security agreement were oral, written or authenticated, it would be necessary to determine the minimum content necessary for the agreement to be in existence. In some legal systems it is necessary only that the security agreement identify the debtor, the creditor, and the collateral. In such case all of the other terms of the transaction, including even the amount and the due date of the obligation for which the security interest was created can be proven in case of dispute by the means available to prove the contents of commercial contracts in general. In other legal systems the required minimum content of a security agreement is more extensive. If an extensive minimum content were required in the uniform rules, it might be thought desirable to specify the extent to which other terms not in the explicit agreement could be proven by the means available to prove the content of commercial contracts in general.

Rights of the secured party on default

44. If the secured party is to be reimbursed from the collateral on the default of the debtor, procedures must be provided which will permit the secured party to realize the economic value of the collateral. That can be done by allowing the secured party (*a*) to take possession and keep the goods, (*b*) to sell the goods, or (*c*) to have the goods sold by a third person. These three basic procedures are not mutually exclusive in that the uniform rules could permit any or all of these procedures to be used either at the discretion of the secured party or under conditions specified in the rules.

45. The rules might provide whether the secured party would be allowed to take possession of the collateral without the intervention of the public authorities. If this were to be permitted, the rules might provide criteria for determining the conditions under which it would be permitted.

46. The rules might provide the extent to which the parties would be allowed to provide for remedies different from those set out in the rules themselves. This could be accomplished by stating specifically certain matters in regard to which the parties were to be allowed to contract. This could also be accomplished by stating certain specific matters in regard to which they would not be allowed to contract.

Types of moveables which may be used as collateral

47. Although in principle there are no assets of a debtor which could not be used as collateral, certain kinds of moveables and moveables which are used in certain ways raise special problems.

48. As was noted above, moveables can become immoveables by attachment to the land or, in some legal systems, by being used in conjunction with the exploitation of the land. Therefore, the uniform rules might consider whether such goods as a steel beam, a furnace or a machine tool remain moveables and subject to the uniform rules after they have been incorporated into a building. Whether or not the rules consider that question, it may be thought to be desirable to determine the relationship between a security interest created in the beam, furnace or machine tool before it was incorporated or installed and an interest in the land itself.

49. Conversely, it may be thought desirable to consider whether a security interest could be created in timber, fruit, crops, minerals and the like prior to the time they are separated from the land.

50. There are special problems in attempting to create a security interest in goods held as inventory for sale. Among these are the difficulty of describing the specific units subject to the security interest, the question of how new units of inventory purchased to replace those sold in the ordinary course of business become subject to the security interest, and the conflict between the purchaser in the ordinary course of business and the secured creditor. If it is considered desirable to facilitate the use of inventory as collateral, special rules on these and related matters would be necessary to make it feasible to do so.

51. Somewhat similar problems are raised if the debtor is to use claims he has against third parties as collateral. Although claims in the form of negotiable instruments can be given as collateral by transferring possession of the instrument, claims which are not in the form of negotiable instruments, such as trade accounts, cannot be given as collateral in this manner. Nevertheless, it may be thought desirable to facilitate the use of claims not in the form of negotiable instruments as collateral, in which case special rules would be necessary.

Conflicts between secured creditor and third parties

52. It would be necessary to determine the third parties who would have prior rights in the collateral as against the secured creditor and those who would be subordinated to the secured creditor.

53. A primary question would be whether a secured creditor would have its priority, whatever that priority might be, by reason of the conclusion of the security agreement or whether it would have to take an additional step to establish its priority. Such additional step might include having the collateral marked with the name of the creditor, having the place where the collateral is located marked with the name of the creditor, or having the agreement filed or registered in a public office.

54. The uniform rules might govern the priorities only between the different creditors who claimed an interest in the collateral by virtue of a security agreement. The rules might also govern the priorities between secured creditors and other creditors who claim an interest in the collateral by virtue of the judgement of a court, by virtue of the operation of law (such as the claim to the goods which an unpaid artisan has repaired), by virtue of a tax claim or by virtue of other rules of law. It might be thought desirable to provide for the priorities in respect of certain of these claims but not in respect of others.

55. It would be necessary to decide whether a purchaser of the collateral purchased it subject to or free of the security interest. It would be possible to differentiate between those purchasers who knew or ought to have known of the security interest and those who neither knew nor had any reason to know of it. If such a differentiation were made, it might be thought that the purchaser ought to have known of the security interest when the collateral or the place the collateral was kept was marked with the name of the creditor or when the security agreement was filed or registered in a public office, as the case may be.

56. Different rules might be considered desirable for a purchaser of goods held as inventory for sale in the event that the uniform rules are designed to facilitate the use of inventory as collateral.

Effect of foreign created security interests

57. Although few legal systems provide for the effect of a security interest created in another State, it might be thought desirable for the uniform rules to do so.

58. One question which might be considered is whether the validity of a security interest—and the agreement by which it was created—are to be determined by the law of the State where the security interest was first created or by the law of the State where the security interest is to be enforced. The problem can arise in two ways. First, the security agreement is validly concluded in the first State but not in the second State, e.g. the second State requires an authenticated instrument whereas the first State requires only that the agreement be in writing. Secondly, the security agreement is not validly concluded in the first State but would be in the second State. In this second case, it might be decided that since the agreement is not valid in the State where it was created, it is not valid in the State where it was to be enforced. Alternatively, it might be held that it is valid in the second State, but only from the moment the collateral enters the second State.

59. A similar question arises when the State where the security interest is to be enforced requires some additional act to create the secured creditor's rights against third parties. It could be decided that if the secured creditor had done all that was necessary in the first State, he should not lose his rights if the collateral is removed from the first State. On the other hand it could be thought that it should be necessary for the secured creditor to have taken the actions required by the law of the second State in order to enforce his security interest in that State against third parties in that State.

Conclusion

60. The Commission may wish to conclude that the subject of security interests is of sufficient importance for it to continue work in respect of it. The importance derives from the fact that, while the use of security interests is an important means of financing commercial transactions, the law in most States is rudimentary and as such is not appropriate to respond to the needs of modern commerce.

61. As was explained in the body of this report, the Secretariat is strongly of the view that, in the present state of development of the law, it would not be feasible to try to achieve unification by means of a uniform law in the form of a convention. Instead, a model law could be devised with suggested alternatives for provisions which present particular difficulties. Such a model law would serve (*a*) to assist countries in modernizing their law in regard to security interests, (*b*) to bring about a common approach to solving the problems inherent in a system of security interests, and thereby (*c*) to place at the disposal of merchants and traders an alternative means of financing commercial transactions.

62. If the Commission were to agree with these policy considerations, it may wish to request the Secretary-General to prepare a preliminary draft with an accompanying commentary and to do so in consultation with interested international organizations and banking and trade institutions.