United Nations A/CN.9/WG.VI/WP.2/Add.4

General Assembly

Distr.: Limited
1 March 2002

Original: English

United Nations Commission on International Trade Law
Working Group VI (Security Interests)
First session
New York, 20-24 May 2002

Security Interests

Draft legislative guide on secured transactions

Report of the Secretary-General

Addendum

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IV. Creation

A. General remarks

1. Introduction

1. As the Guide deals almost exclusively with contractual security rights (statutory or judicial security rights are only marginally mentioned, e.g. in the context of conflicts of priority; see Chapter XI), this Chapter outlines the contractual basis for creating a security right. As contract alone is usually not sufficient to create an effective security right, this Chapter also discusses the additional requirements (i.e. transfer of possession, publicity or control). Before discussing the security agreement (see section A.3) and the additional requirements for the creation of an effective security right (see section A.4), this Guide outlines the two basic elements of both, namely the obligations to be secured (see section A.2.a) and the assets to be encumbered (see section A.2.b)

2. As distinct from ownership, which, in principle, does not allow ranking of several owners, no such monopoly exists for security rights. Several security rights in one asset can be ranked and therefore can co-exist. Admitting the co-existence of several security rights in the same asset enables the grantor to make full use of the economic value of the asset. Such co-existence is made possible by ranking the security rights according to the time an act is completed (e.g. creation, publicity or control; for the conditions and effects of ranking, see Chapter VII).

3. Even if a security right has been validly created, it may nevertheless fail to fulfil its most important function, i.e. to ensure a preference to the secured creditor in the debtor's insolvency. This may occur, for example, where the creation of the security right contravenes provisions of insolvency law on the invalidity of dispositions of the debtor in the suspect period preceding the opening of an insolvency proceeding (for details, see Chapter X).

2. Basic elements of a security right

4. Normally, the security is accessory to the secured obligation. This means that the validity and the terms of the security depend on the validity and the terms of the secured obligation. In particular, the terms of the security cannot surpass the terms of the secured obligation (but they may be reduced if the parties agree). This principle has been somewhat restricted in order to accommodate modern financing practices that require the security to be somewhat independent of the secured obligation (e.g. revolving credit transactions). However, it is still one of the main principles of secured credit law.

a. Obligations to be secured

i. Limitations

5. In countries with legislation only on specific types of non-possessory security, secured obligations are limited to those described in such legislation (e.g. loans for the purchase of automobiles or loans to farmers).

6. No such limitations exist in countries with a general regime for possessory only, or also for non-possessory, security rights. However, even within a regime of unified rules some functional distinctions may be necessary for practical reasons (e.g. to give priority to claims for purchase money).

7. In the interest of consistency and equal treatment of all debtors and secured creditors, functional distinctions of secured obligations should be avoided, if possible. Such special regimes should only be introduced or maintained where, for special reasons (especially social protection or grave economic imbalance), a protective regime is thought to be necessary. In any case, where necessary, special regimes should be specifically established by national legislators and not be prescribed for a broad variety of obligations.

ii. Varieties of obligations

(a) Monetary and non-monetary obligations

8. Like most national laws, the Guide proceeds on the assumption that, in practice, the most important type of secured obligations are monetary obligations. There are, however, also cases where there is a demand to secure performance of non-monetary obligations (e.g. for delivery of goods). This is accepted in many jurisdictions, provided that the secured non-monetary obligations can be converted by the time of enforcement into monetary obligations.

(b) Type of the monetary obligation

9. From a legislative point of view, an exhaustive listing of the potential sources of monetary obligations that can be secured is impossible. In addition, it is unnecessary since the legal source is irrelevant for the purposes of security, unless there is a special regime (e.g. for loans by pawnbrokers). An indicative list of such monetary obligations would typically include obligations from loans and the purchase of goods on credit.

(c) Future obligations

10. Securing present obligations, i.e. obligations that have arisen before or at the same time when the security right is created, does not pose particular problems. Securing future obligations, i.e. those arising after creation of the security right, while potentially giving rise to certain questions, is of great economic importance (e.g. for revolving loan transactions; see A/CN.9/WP.2/Add.2, paras. 8-10). It would be a significant burden on business practice if each prolongation or increase of credit would require that the corresponding security be modified or even newly created.

11. For this reason, many jurisdictions recognize security for future obligations. The potential inconsistency with principle of the accessory character of security right (according to which the validity and terms of the security right depend on the validity and the terms of the secured obligation) is more apparent than real, since, while the security is created before, it does not have any effect until the secured obligation actually arises. In some jurisdictions, limits on future obligations are introduced in the interest of protecting the debtor. As a result, it may not be possible

for the debtor to benefit from transactions, such as those relating to revolving loan facilities.

12. Obligations subject to a condition subsequent are present obligations and, therefore, do not raise particular issues. Obligations subject to a condition precedent are normally treated like future obligations (see paras. 10-11).

(d) One, several or all obligations/maximum amount

13. In some legal systems, there is a need to describe or set a maximum limit to the secured obligation. The assumption is that such description or limit is in the interest of the debtor. However, such requirements may inadvertently result in limiting the amount of credit available or in increasing the cost of credit. This is the main reason why modern legal systems do not require specific descriptions and allow "all sums" clauses or, at least, do not set maximum limits for secured obligations (see paras. 14 and 16). The secured creditor cannot claim more than it is owed and, if the obligation is fully secured, better credit terms are likely to be offered to the debtor.

(e) Fluctuating amount of obligation

14. As noted above (see para. 10), modern financing transactions no longer involve a one-time payment but frequently foresee advances being made at different points of time depending on the needs of the debtor. Such financing may be conducted by a current account, the balance of which fluctuates daily. If the amount of the secured obligation were to be reduced by each payment made (in line with the principle of the accessory nature of security), lenders would be discouraged to make further advances unless they were granted additional security. This result could be avoided by a reasonable interpretation of the parties' intention, which would be to determine the amount of the secured obligation by the (fluctuating) amount of the balance of the current account, without regard to any intermediate lower maximum amount.

(f) Foreign currency

15. The amount of the secured obligation may be expressed in any currency. Occasionally, difficulties of conversion into the currency of the place of payment, execution or insolvency may arise. This matter may be left to the agreement of the parties, which should be in line with the relevant laws.

iii. Description

16. A specific description of each secured obligation is usually not necessary (see para. 13). However, the secured obligations and their amounts must be determined or determinable whenever a determination is needed (e.g. upon enforcement by the secured creditor or upon execution by another creditor of the debtor) on the basis of the security agreement.

b. Assets to be encumbered

i. Limitations

17. As in the case of special regimes for certain types of secured obligations (see para. 5), special laws for specific types of non-possessory security rights may introduce limitations as to the types of asset that may serve as security. Assets that may not be encumbered are, for example, wages, pensions and essential household goods (except as security for obligations to pay their purchase price).

18. In the absence of public policy reason for such regimes, it should be possible to create a security right in all types of asset, tangible or intangible, including rights to payment or other performance. Even monetary claims of the debtor against the secured creditor should be able to serve as security.

ii. Future (including after-acquired) assets

19. The issue of whether future assets may be encumbered is of great practical importance. The term "future" is given a broad meaning. It covers assets that already exist at the time of the conclusion of the security agreement but do not belong to the debtor (or the debtor cannot dispose of them). It also covers assets that, at that point of time, do not even exist.

20. In some countries, the parties may agree to create a security right in a future asset of the debtor. The disposition is a present one but it becomes effective only when the debtor becomes the owner of the asset or becomes otherwise entitled to dispose of it. The United Nations Convention on the Assignment of Receivables in International Trade, adopted by the General Assembly on 12 December 2001 ("the Assignment Convention") takes this approach (see art. 8 (2) and art. 2 (a)).

21. This is important, in particular, for revolving loan transactions (see para. 10). Assets to which this technique is typically applied are inventory, which by its nature is to be sold and replaced, and receivables, which after collection are replaced by new receivables. The main advantage of this approach is that one security agreement suffices to create a security in a succession of assets that fit the description in the security agreement. Otherwise, successive acts of creating new security rights would be necessary, a result that would increase the cost of the transaction. The same technique can also be applied if the security is to be fixed in an individual asset to be produced by the debtor or to be acquired by the debtor from another person.

22. In contrast, many other jurisdictions do not allow the creation of security in future assets. This is partly based upon technical notions of property law. Another reason is the concern that allowing broad dispositions of future assets may excessively burden the debtor's property, preventing the debtor from obtaining additional secured credit from other sources (see para. 26). Furthermore, the likelihood of unsecured creditors of the debtor obtaining satisfaction for their claims may be significantly reduced.

23. A proper balancing of the various interests may be difficult to achieve, in particular if the legal regime covers also non-commercial transactions. In a business context, it may be excessive to bar the charging of future assets of the debtor

altogether because of possible, but uncertain, negative consequences in the future. It may be preferable to impose limitations only if, and when, dire consequences are likely to occur (e.g. in cases of conflicts with unsecured creditors). Any dilemma of this type may best be resolved, if and when it occurs, as an issue of priority (see Chapter VII).

iii. Assets not specifically identified

24. Some types of asset, especially equipment, are stable and not subject to frequent dispositions and replacement. They can therefore be individually described and identified. This is not possible for other types of asset, especially inventory and, to some degree, receivables. For these (and other comparable) situations, many countries have developed rules that enable the parties to contractually identify the assets to be encumbered as a prerequisite for a valid disposition, even though the individual elements change (they are disposed of and regularly replaced). The specific identification, generally required, is transposed from the individual items to an aggregate, which in turn has to be specifically identified. For example, in the case of receivables, it is sufficient to identify them by referring to "all debtors with initials A to G". In the case of inventory, a sufficient identification may be "all assets stored in the debtor's business premises room A".

25. In some legal systems, even a description referring to all assets, present and future, may be sufficient. In some other legal systems, an all-assets security is not allowed with respect to consumers or even individual small traders.

26. Related to, though distinguishable from, the all-assets security is the issue of over-collateralization, i.e. where the value of the security significantly exceeds the amount of the secured obligation. In accordance with the principle of the accessory nature of security rights, the debtor is not harmed because the secured creditor cannot realize or claim more than its secured claim plus interest and expenses (and perhaps damages). The question, however, is whether the excessive security ties up the debtor's assets. In legal systems that allow the same asset to be given as security to more than one creditor that have a different ranking, this problem may not arise. In legal systems where this may not be the case, over-collateralization may be addressed by parties setting maximum limits for the amount of the secured obligation and, if necessary, by reducing the security given to correspond to the amount of the secured claim.

27. Several countries provide for an institutionalized form of an all-assets security in the form of an "enterprise mortgage". One type of such mortgages is a small enterprise mortgage, which is essentially limited to intangibles such as trade names, the clientele or intellectual property rights (see article 69 of the OHADA Uniform Act). Due to its limited scope, this mortgage is of limited importance.

28. In contrast, the large enterprise mortgage plays a major role as security in the countries that have adopted it. A large enterprise mortgage may comprise all movable assets of an enterprise, whether tangible or intangible, although it may be limited to divisible parts of an enterprise. It does not comprise immovables, since they are subject to a distinct regime. As enterprise mortgages are distinct from mortgages in immovables, it is necessary to clarify the treatment of fixtures that may be subject to such mortgages.

29. A large enterprise mortgage is comparable to a regime where security may be taken over all assets of a debtor. An interesting aspect of this type of security is that, not only upon the debtor's insolvency, but, in some countries, even upon enforcement by the secured creditor and upon execution by another creditor, an administrator can be appointed for the enterprise. The appointment of an administrator may assist in avoiding liquidation and in facilitating reorganization of the enterprise with beneficial effects for creditors, the workforce and the economy in general. This special feature is not exclusively part of an enterprise mortgage but might be considered generally for security rights and executions. However, to date, the institutional enterprise mortgage may offer the best vehicle for realizing this idea.

c. Proceeds

i. Definition

30. When encumbered assets are disposed of (or leased or licensed) during the time in which the indebtedness they secure is outstanding the debtor may receive, in exchange for those assets, cash or other tangible or intangible property. Such payment is referred to in many legal systems as "proceeds" of the collateral. In some cases, the original encumbered asset may generate proceeds that the debtor then sells, exchanges or otherwise disposes of in return for other property. Such proceeds are referred to as "proceeds of proceeds".

31. In other situations, the encumbered asset may generate other property for the debtor even without a transaction occurring. Such assets, which are referred to in some legal systems as "civil" or "natural proceeds", include, for example, interest or dividends on financial assets serving as security, insurance proceeds, newborn animals and fruits of crops. Other legal systems do not distinguish between these sorts of proceeds and proceeds arising from transactions entered into by the debtor.

ii. The nature and extent of the creditor's right

32. Whenever, through a transaction or otherwise, the debtor obtains rights in proceeds of the original encumbered asset, two issues arise that must be addressed in a legal system governing security rights. The first issue is whether the creditor retains any security rights in an encumbered asset that is transferred from the debtor in the transaction generating the proceeds (for a discussion of this question, see paras. …).

33. The second issue concerns the creditor's rights with respect to the proceeds. A legal system governing security rights should provide clear answers to these questions:

(i) whether the creditor has a claim with respect to proceeds;
(ii) the circumstances under which such claim arises;
(iii) the (proprietary or personal) nature and extent of such claim;
(iv) the extent to which property must be "identifiable" as proceeds in order for a right in them to arise;
(v) how situations in which the original encumbered asset becomes intermingled with or incorporated in other property are to be treated, in particular with respect to the relative priority of the right of the

secured creditor as against other parties who may have interests in that other property;

(vi) whether such a claim arises even if it was not provided for in the agreement between the parties; and

(vii) whether "proceeds of proceeds" should be treated in the same way as initial proceeds of encumbered assets.

34. The justification for a right in proceeds lies in the fact that, if the creditor does not obtain rights in the proceeds of the original encumbered asset, the value of security rights as a source of credit will be diminished. On the other hand, granting the secured creditor a proprietary right in proceeds of the encumbered asset might result in frustrating legitimate expectations of parties with a security right in proceeds as original encumbered assets, at least in legal systems in which there is no publicity system for such rights. In legal systems in which such publicity is foreseen and provides a basis for a comprehensive approach towards all conflicts of priority, this matter does not raise serious difficulties, at least to the extent that there are clear rules with respect to the tracing of proceeds.

3. Security agreement

a. Definition

35. The security agreement is the agreement between the creditor and the debtor or a third-party security provider that constitutes (or is one of the constitutive elements of) a security right. The security agreement should be distinguished from an agreement to create security in the future (e.g. if a credit is extended to the debtor). Only the security agreement may have proprietary consequences (for additional proprietary requirements, see section A.4).

b. Minimum contents

36. Legislation often sets forth the minimum contents of a security agreement in order to protect parties. A failure to provide the required minimum contents will normally result in the security being null and void. Minimum contents may include:

(i) Identification of the parties;

(ii) Description of the obligation to be secured;

(iii) Description of the encumbered assets;

(iv) Signature of the grantor of the security, by hand or in electronic form; and

(v) Date of the agreement, unless the date is established by registration.

37. Even in jurisdictions where legislation does not specifically prescribe such minimum contents, a security agreement that is missing one of the elements mentioned above may be held to be null and void.

38. Parties normally negotiate additional clauses, in order to clarify their relationship. From a legislative point of view, it is advisable to have default rules in the absence of a specific agreement of the parties (for pre-default effects see Chapter VIII; for post-default effects, see Chapters IX and X).

c. Formalities

i. Writing

39. In order to promote certainty as to the rights of the parties to the security agreement and of third parties, many legal systems require a written document for the security agreement to be valid. In particular if the use of modern means of communication is permitted, the written form requirement need not create problems of time and cost. Such a requirement may be dispensed with for certain transactions, especially possessory pledges, since third parties are already protected to some degree by the debtor's dispossession.

ii. Additional formalities

40. In some legal systems, a certification of the date by a public authority may be required for possessory pledges, with the exception of small amount loans where proof even by way of witnesses is permitted. The advantage of such certification is that it helps to avoid fictitious dating, although it may be a costly and lengthy process.

41. In other legal systems, a certified date or authentication of the security agreement is required for various types of non-possessory security (see, e.g., articles 65, 70, 94 and 101 of the OHADA Act). While certification is more important for non-possessory security in order to avoid false dating, it is not necessary where publicity is a condition for effectiveness as against (or priority over) third persons (see Chapters V and VI).

42. In legal systems that have enterprise mortgages (see paras. 27-29), a written document or even a notarial, or equivalent court or other, document may be required. While such a requirement appears to be excessive, it may be justified by the fact that it may facilitate enforcement.

43. In the interest of saving time and cost, formalities should be kept to a minimum. For non-possessory security rights, a simple written communication (including modern means of communication) should be sufficient. For enterprise mortgages or cases where the security agreement is sufficient title for execution, a more formal document may be considered.

d. Effects

44. Upon conclusion, the security agreement becomes immediately effective between the parties, unless otherwise agreed. Whether any additional steps are necessary differs from country to country. Even within one and the same jurisdiction, the answer may vary for different kinds of security rights. In addition, the issue of what proprietary effects will ensue is not uniformly resolved.

45. In many legal systems in which property rights are only those that can be asserted as against all persons, the security agreement alone does not suffice to create the security right. In other legal systems, in which a distinction is drawn between proprietary effects *inter partes* and as against third persons, the security agreement is sufficient to create the security right but, if there are competing claims, the claimant that has first met an additional requirement has priority. In both

categories of legal systems, in addition to the security agreement, an act such as delivery of possession, publicity or control is required. In some countries, there are certain exceptions to this rule for retention and transfer of title arrangements.

46. Where delivery of possession is required, a fictitious transfer by way of an additional agreement (of deposit or security) that superimposes on the debtor's direct possession the creditor's indirect possession (*constitutum possessorium*), may be sufficient. The same applies to situations in which, in the case of a sale or rent on credit, title is retained by a seller or lessor until full payment of the price or rent. The seller's or the lessor's retention of title normally means that, upon payment of the purchase price and performance of any additional secured obligation, title passes to the buyer. In countries where retention of title is absorbed by a uniform comprehensive security right, another approach is taken. Title is transferred to the buyer under the ordinary rules, but the seller retains a security right in order to secure payment of the purchase price (or performance of additional obligations).

4. Additional requirements

a. Introduction

47. As mentioned above (see para. 45, in many legal systems, the conclusion of a valid security agreement alone does not suffice to create a valid and effective security right. Additional requirements must normally be met for the security right to be effective vis-à-vis third persons (or to have priority over competing claimants). In the countries that do not recognize proprietary effects only between the parties to the security agreement, no proprietary effects can come into existence before these additional requirements have been met.

b. Right of disposition of grantor

48. The grantor of a security (normally the debtor and exceptionally a third person) must have the right to create the security. In some legal systems, the grantor has to be the owner of the assets to be encumbered. In other legal systems, it is sufficient if the grantor has the power to dispose of the assets even if the grantor is not the owner. With respect to future assets, it suffices if the grantor will become the owner, or will obtain the power of disposition at a future time (see paras. 20-21).

49. Where the grantor does not have the right or the power to dispose of the assets, the question arises whether the secured creditor can nevertheless acquire the security in good faith. In some legal systems, the creditor acquires the security right if the subjective good faith is supported by objective elements. These elements include that: the creditor has or is about to extend credit to the debtor; the grantor is registered as owner or holds and transfers possession to the creditor.

50. Legislation on this subject often addresses the related issue of the validity and the effect of contractual restrictions on dispositions. In some countries, the need to preserve the debtor's freedom of disposition prevails, in particular if the creditor in whose favour the security has been created is not aware of the restrictive clause. The Assignment Convention takes a similar approach to support transferability of a claim for the sake of commerce. Under article 9 of the Convention, the assignment is effective despite a contractual restriction on

assignment and mere knowledge of the existence of the restriction is not enough for the avoidance of the contract from which the assigned claim arises. The party, in whose favour the negative pledge or no-assignment clause had been agreed, may remain free to claim damages from its contracting party for breach of the restraining contract clause, if such a claim exists under law outside the Convention. However, this claim may not be raised against the assignee by way of set-off (see article 18, paragraph 3).

51. This approach promotes the granting of secured credit since it relieves the creditor of the task of having to examine the contract from which the assigned claim arose, in order to ascertain whether transfer of the claim has been prohibited or made subject to conditions. Otherwise, lenders would have to examine potentially a large number of contracts which may be costly or even impossible (e.g. in the case of future claims).

c. Transfer of possession, publicity and control

52. The methods of producing proprietary effects (or establishing priority over competing claimants) vary from country to country, and even within individual countries, according to the type of security involved. There are three main methods of creating a security right that is effective as against all persons (although, as mentioned above, in some countries a distinction is drawn between proprietary effects as between the parties and proprietary effects as against third parties).

i. Transfer of possession

53. The possessory pledge is created by agreement and transfer of possession of the asset to the creditor. Possession must be transferred to, and must remain with, the secured creditor or an agreed third person that usually acts as the creditor's agent. Fictitious transfers of possession are also foreseen (see para. 46), but are not necessary in legal systems that admit non-possessory pledges. Possession can also be transferred by the delivery of negotiable instruments or documents, with an endorsement if necessary under the rules governing negotiable instruments.

ii. Publicity or control

54. With the exception of cases where the security agreement suffices to create a security right, some form of publicity or control is required for the creation of non-possessory security rights and for their effectiveness as against third parties (or priority over competing claimants). Publicity or control may also be a condition for effectiveness against third parties or priority (for details on the forms, functions and effects of publicity, see Chapters V and VI).

B. Summary and recommendations

55. In a modern secured credit law, it should be possible to secure all types of obligations, including future obligations, and to provide security in all types of asset, including assets of which the debtor may not dispose or which do not exist at the time of creation of security right.

[*Note to the Working Group: The Working Group may wish to consider whether any exceptions to this rule should be introduced. In addition, the Working Group may wish to consider the comparative advantages and disadvantages of a regime where security can be taken over all assets of any debtors, business debtors or just enterprises.*

56. The secured creditor should also be given a right in readily identifiable proceeds.

[*Note to the Working Group: The Working Group may wish to consider the nature and the extent of the right in proceeds. Particular questions to be addressed include the following: whether the right in proceeds is a personal or a property right; whether it has the same priority with respect to the rights of competing claimants the security right in the encumbered assets; and whether it covers proceeds of proceeds.*]

57. The security agreement should be in written form, which should include modern means of communications. It should identify the parties and reasonably describe the encumbered asset and the secured obligation.

[*Note to the Working Group: The Working Group may also wish to consider whether any exceptions to the written form rule should be introduced. It may also wish to consider additional elements for the minimum contents of the security agreement, as well as the effect of the security agreement and any additional requirements for the constitution of a security right.*]