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Security Interests

Draft legislative guide on secured transactions

Report of the Secretary-General

Addendum

Contents

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IV. Creation

A. General remarks

1. Introduction

1. This Chapter deals with issues relating to the contractual basis for creating a security right (statutory or judicial security rights are only mentioned in the context of conflicts of priority; see A/CN.9/WG.VI/WP.2/Add.7, paras. 33-39). As the agreement of the parties alone is usually not sufficient to create a security right, this Chapter also discusses the additional, proprietary requirements, such as transfer of possession, notification, publicity or control. Before dealing with the issues relating to 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. The time of the conclusion of the security agreement or of the completion of an additional act is important for ranking security rights in the same asset (for the conditions and effects of ranking, see A/CN.9/WG.VI/WP.2/Add.7). As distinct from ownership, which, in principle, does not allow ranking of several owners, several security rights may be ranked and thus coexist in the same asset. The coexistence of several security rights in the same asset enables the debtor or other grantor to make full use of the economic value of the asset.

3. Even if a security right has been validly created, it may nevertheless fail to fulfil its most important function, i.e. to ensure priority in the case of the debtor's insolvency. This may occur, for example, where the creation of the security right contravenes prohibitions of insolvency law against preferential transfers made in the suspect period preceding the opening of an insolvency proceeding or contravenes applicable fraudulent transfer laws (for details, see A/CN.9/WG.VI/WP.6/Add.5).

2. Basic elements of a security right

a. Obligations to be secured

i. Connection between security and secured obligation

4. Security rights are accessory to, or dependent upon, the secured obligation. This means that the validity and the terms of the security agreement depend on the validity and the terms of the agreement giving rise to the secured obligation. In particular, the terms of the security right (e.g. the amount of the claim) cannot surpass the terms of the secured obligation (but they may be reduced if the parties agree). In order to accommodate modern financing practices (e.g. revolving loan facilities), the secured obligation does not need to be specific but can encompass future obligations and fluctuating obligations (see paras. 9-15). In countries where retention of title is not assimilated to a security right, the principle of the accessory character of the security right does not govern title-based security rights (see A/CN.9/WG.VI/WP.6/Add.2, paras. 29-42). In such cases, the creditor's position is stronger since it does not need to prove the outstanding amount of the secured obligation in order to enforce its claim. However, the debtor may require the creditor to return any surplus obtained over the debtor's indebtedness.

ii. Limitations

5. In some countries, non-possessory security may relate only to specific types of obligations described in legislation (e.g. loans for the purchase of automobiles or loans to farmers). In other countries with a general regime for possessory only or also for non-possessory security rights, no such limitations exist. Such a comprehensive approach has the potential of spreading the main benefits from secured financing (i.e. greater availability of credit and at a lower cost) to the parties to a wide range of transactions. To the extent that no such limitations or distinctions of secured obligations are introduced, this approach may also enhance certainty.

6. In order to ensure certainty, consistency and equal treatment of all debtors and secured creditors, special regimes applicable to various types of obligations should be avoided to the extent possible. In situations where such special regimes are necessary for special socio-economic reasons, they should be specifically established by national legislators and not be prescribed for a broad variety of obligations. Such a specific regime may relate, for example, to obligations for payment of purchase money secured with a retention of title, which is generally given priority because of the importance of supplier or other purchase money credit for the economy (see A/CN.9/WG.VI/WP.6/Add.2, para. 36 and A/CN.9/WG.VI/WP.6/Add.5, para. 12).

iii. Varieties of obligations

(a) Monetary and non-monetary obligations

7. Following the example of most national laws, the regime envisaged in the Guide is based on the assumption that, in practice, the most important type of secured obligations is monetary obligations. At the same time, the Guide takes into account the widely recognized need to allow security for the performance of non-monetary obligations (e.g. for delivery of goods). However, in order to be enforceable against the encumbered asset, non-monetary obligations should be convertible to monetary obligations by the time of enforcement.

(b) Type of monetary obligation

8. It is neither possible nor necessary to list in legislation the potential sources of monetary obligations that can be secured. There is a wide range of potential sources and, in any case, the legal source is irrelevant, unless there is a special regime for security rights in specific types of obligations (e.g. for loans by pawnbrokers). An indicative list of such monetary obligations would typically include obligations arising from loans and the purchase of goods, including inventory and equipment, on credit.

(c) Future obligations

9. Legal systems may differ on the distinction between “present” and “future” obligations. In some systems, an obligation is future if it is not due. In other systems, it is future if the contract from which it may arise has not been concluded at the time it is transferred or encumbered (see article 5 (b) of the United Nations Convention on the Assignment of Receivables in International Trade; “the United Nations Assignment Convention”). The former approach is aimed at enhancing certainty and debtor protection, while the latter approach, in the interest of the

economy as a whole, is aimed at validating transactions relating to future obligations. Such transactions securing future obligations are of great economic importance (e.g. revolving loan transactions; see A/CN.9/WG.VI/WP.6/Add.1, paras. 21-23). If each extension or increase of credit were to require that the corresponding security right be modified or even newly created, this could have a negative impact on the availability and the cost of credit.

10. For this reason, modern legal systems recognize security for future obligations. The potential inconsistency with the principle of the accessory character of security rights (see para. 4) is more apparent than real, since, while the security right may be created before, it cannot be enforced until the secured obligation actually arises. In some jurisdictions, in order to protect debtors from over-indebtedness, future obligations may be secured up to a maximum amount. A potential disadvantage of such an approach is that it may not be possible for the debtor to benefit from certain transactions, such as revolving loan facilities (see also para. 13).

11. 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. 9-10).

iv. Description

(a) General

12. While a specific description of each secured obligation is usually not necessary, the secured obligation must be determined or determinable on the basis of the security agreement whenever a determination is needed. Such determination is needed, for example, upon enforcement by the secured creditor or upon execution by another creditor of the debtor.

(b) Maximum amount

13. In some legal systems, it is necessary for the parties to describe in specific terms the secured obligation in their agreement or to set a maximum limit to it. The assumption is that such description or limit is in the interest of the debtor since it would be protected from over-indebtedness and would have the option of obtaining additional credit from another party. However, such requirements may inadvertently result in limiting the amount of credit available and thereby in increasing the cost of credit. This is the main reason why many legal systems do not require specific descriptions and allow “all sums” clauses or, at least, do not set maximum limits for secured obligations (see also paras. 10 and 14). This approach is based on the assumption that the secured creditor cannot claim more than it is owed and that, if the obligation is fully secured, better credit terms are likely to be offered to the debtor (see also A/CN.9/WG.VI/WP.2/Add.5, paras. 35-37 and A/CN.9/WG.VI/WP.2/Add.6, paras. 11-12).

(c) Fluctuating amounts

14. As already noted (see para. 9 and A/CN.9/WG.VI/WP.6/Add.1, paras. 21-23), modern financing transactions often 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 from making further advances unless they were granted additional security. The law should, therefore, validate rights securing future advances.

(f) Amounts in 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. However, in the interest of certainty, a secured transactions law should provide that, in the absence of an agreement, the amount of the secured obligation should be converted into the domestic currency.

b. Assets to be encumbered

i. Object of the security right

16. The object of the security right is the debtor's or (in cases where security is provided by a third party) the grantor's ownership (title) in the encumbered asset (including future assets; see para. 61). In the case of a security right in a receivable, it is the grantor's title in the receivable that is being encumbered. However, it is also possible to encumber a limited proprietary right, such as a right of use or a lease. In such cases, the secured creditor's rights are as limited as the encumbered right of use or lease and are subject to any overriding rights of the owner.

ii. 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 introduce limitations as to the types of asset that may serve as security. Assets that may not be encumbered at all or may be encumbered only subject to limitations (e.g. a minimum value that may not be encumbered), may include, for example, wages, pensions and essential household goods (except as security for obligations to pay their purchase price).

18. In the absence of a public policy reason for such special regimes, it should be possible to create a security right in all types of asset, tangible or intangible, such as receivables and other rights, including counter-claims of debtors against secured creditors.

iii. Future assets

19. The issue of whether future assets may be encumbered is of great practical importance. The term "future" 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. In both cases, it is assumed that the assets can be encumbered.

20. In many 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 Assignment Convention takes this approach (see art. 8 (2) and art. 2 (a)).

21. Permitting the use of future assets as security for credit is important, in particular, for securing claims arising under revolving loan transactions (see paras. 9-10) by a revolving pool of assets. Assets to which this technique is typically applied include 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 may cover a changing pool of assets that fit the description in the security agreement. Otherwise, successive acts of creating new security rights would be necessary, a result that could increase transaction costs.

22. In some countries, future assets may not be used as security. This approach is partly based upon technical notions of property law (what does not exist cannot be transferred or encumbered). Another reason is the concern that allowing broad dispositions of future assets may inadvertently result in over-indebtedness and in making the debtor excessively dependent on one creditor, preventing the debtor from obtaining additional secured credit from other sources (see para. 26). Yet another reason for not permitting the creation of security rights in future assets is that the possibility that unsecured creditors of the debtor will obtain satisfaction for their claims may be significantly reduced.

23. Technical notions of property law should not be invoked to pose obstacles to meeting the practical need of using future assets as security to obtain credit. In addition, business debtors can protect their own interests and do not need statutory limitations on the transferability of future assets. Moreover, unsecured creditors could be protected by appropriate rules of priority. Such rules could provide, for example, that, in the case of a conflict of priority between a secured creditor with a security right in all assets of a debtor and unsecured creditors, a certain part of the debtor's assets may be kept aside for the satisfaction of unsecured creditors (see paras. 26 and 32, as well as A/CN.9/WG.VI/WP.6/Add.5, paras. 26-28).

iv. 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. Such specific identification, however, may not be possible for other types of asset, especially inventory and, to some degree, receivables. To address this problem, many countries have developed rules that allow the parties to describe only in general terms the assets to be encumbered. 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 may be 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, is sufficient (e.g. "all my assets, presently owned and after acquired"). In some of these legal systems, such an all-assets security is not allowed with respect to consumers or even to individual small traders.

26. Related to, though distinguishable from, the all-assets security is the issue of over-collateralization, which arises in situations where the value of the security significantly exceeds the amount of the secured obligation. While the secured

creditor cannot claim more than its secured claim plus interest and expenses (and perhaps damages), over-collateralization may create problems. The debtor's assets may be encumbered to an extent that makes it difficult or even impossible for the debtor to obtain a second-ranking security from another creditor. In addition, executions by the debtor's unsecured creditors may be precluded or at least be made more difficult. Title-based security rights present the same problem. A solution developed by courts in some countries is to declare any excess security void or to grant the debtor a claim for release of such excess security (see paras. 23 and 32, as well as A/CN.9/WG.VI/WP.6/Add.5, paras. 26-28). This solution could work in practice, provided that a commercially adequate margin is granted to the secured creditor.

v. Enterprise mortgages and floating charges

27. In some countries, all-assets security takes the form of enterprise mortgages or floating charges. One type of such mortgage 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. By contrast, the large enterprise mortgage plays a major role as security in some countries. 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. Usually, it does not comprise immovables, since they are subject to a distinct regime (as to fixtures, see paras. 34-35).

29. The most essential aspect of an enterprise mortgage is that the debtor-enterprise has the authority to dispose of its encumbered assets in the ordinary course of its business and that the security attaches automatically to the proceeds taking the place of the disposed assets. Under most legal systems, such an authority to dispose of encumbered assets is admissible without affecting the security right. However, in certain legal systems, dispositions of encumbered assets by the debtor, although authorized by the creditor, are regarded as irreconcilable with the idea of a security right. In some of these legal systems, the courts invented the idea of a "floating" charge, which is merely a potential property right with a licence to the debtor-enterprise to dispose of the assets in the normal course of business. Dispositions are barred as of the time the debtor is in default, when the floating charge "crystallizes" to become a fully effective "fixed" charge.

30. An interesting advantage of large enterprise mortgages is that upon enforcement by the secured creditor and upon execution by another creditor, an administrator can be appointed for the enterprise. This may assist in avoiding liquidation and in facilitating reorganization of the enterprise with beneficial effects for creditors, the workforce and the economy in general. In practice, however, administrators appointed by the secured creditor may favour the secured creditor. This problem may be mitigated to some extent if the administrator is appointed by a court or other authority.

31. However, large enterprise mortgages present other disadvantages in practice. One disadvantage is that the secured creditor usually is or becomes the firm's major or even exclusive credit provider. Although competition by another credit provider offering better terms is not necessarily precluded, such a situation is, in principle,

undesirable. Another disadvantage is that, in practice, the holder of the mortgage often fails to sufficiently monitor the firm's business activities and to actively participate in reorganization proceedings since the mortgagee is amply secured.

32. In order to counterbalance the mortgagee's overly strong position, the debtor-enterprise may be given a claim for the release of grossly excessive security (see para. 26). Following the example of some countries, one may also consider mitigating the mortgagee's priority in the case of the enterprise's insolvency (see paras. 23 and 26, as well as A/CN.9/WG.VI/WP.6/Add.5, paras. 26-28).

33. In a modern secured transactions system, which allows security to be taken in all assets of a commercial debtor (whether incorporated or individual), the particular construction or the terminology of an "enterprise mortgage" or a "floating" need not be preserved. What is important is to preserve the functional characteristics of these devices. This means that a non-possessory security right in all assets of a debtor could be created and that the debtor could be given a right to dispose of the encumbered assets in the ordinary course of its business.

[*Note to the Working Group: The Working Group may wish to consider whether, in the case of enforcement of a security right in all assets of a debtor, an administrator by a court or other authority could be appointed*.]

vi. Fixtures

34. Fixtures are movables, especially equipment, attached to immovable property. This attachment raises the question whether fixtures continue to be governed by the law governing movable property (and the rights in them are preserved) or they become subject to the law governing immovable property (and the rights in them are extinguished). In many countries, fixtures or attachments that may not be easily separated become subject to the law governing immovable property and any previous rights in such fixtures or attachments may be extinguished (whether holders of such rights have a right to be compensated is a separate question). The determination whether a fixture may be easily separated is made on the basis of criteria, such as technical difficulty or cost (compared to the value of the fixture).

35. In those countries, fixtures that may easily be separated from the immovable property to which they have been attached do not become subject to the rights in the immovable property, if the owner of the fixtures and the owner of the immovable are different persons. This rule applies to a supplier with a retention of title in fixtures (typically equipment) and should apply to other secured creditors providing money for the purchase of the encumbered assets ("purchase money secured creditors"). Otherwise, the rights of purchase money secured creditors would be expropriated and the owner or mortgagee of the immovable property would be unjustly enriched. Such an approach would not result in frustrating legitimate expectations of third parties, if retention of title arrangements with respect to such fixtures could be noted in the land register, which is already possible in many countries.

[*Note to the Working Group: The Working Group may wish to extend to holders of security rights securing purchase money for fixtures the right to register rights in fixtures in the land registry. Such an approach would prevent both the "expropriation" of the creditor's security rights in fixtures and the unjustified enrichment of the real estate mortgagee*.]

c. Proceeds

i. Introduction

36. When encumbered assets are disposed of (or leased or licensed) during the time in which the indebtedness they secure is outstanding, the debtor typically receives, in exchange for those assets, cash, tangible property (e.g. goods or negotiable instruments) or intangible property (e.g. receivables or other rights). Such cash or other tangible or intangible property is referred to in many legal systems as "proceeds" of the encumbered assets. In some cases, the original encumbered assets may generate proceeds that generate other proceeds when the debtor sells, exchanges or otherwise disposes of the original proceeds in return for other property. Such proceeds are referred to as "proceeds of proceeds".

37. In other situations, the encumbered asset may generate other property for the debtor even without a transaction occurring. Property generated in this way by encumbered assets is referred to in some legal systems as "civil" or "natural fruits". Such property may include, for example, interest or dividends on financial assets, insurance proceeds, new-born animals and fruits or crops.

38. In some legal systems, civil or natural fruits and proceeds are clearly distinguished and made subject to different rules. The difficulty in identifying proceeds and the need to protect rights of third parties in proceeds is often cited to justify this approach. Other legal systems do not distinguish between civil or natural fruits and proceeds and subject both to the same rules. The difficulty in distinguishing between civil or natural fruits and proceeds, the fact that both civil or natural fruits and proceeds flow from, take the place of or may affect the value of the encumbered assets are among the reasons mentioned to justify this approach.

39. A legal system governing security rights must address two distinct questions with respect to proceeds and civil or natural fruits (hereinafter referred to collectively as "proceeds", unless otherwise indicated). The first issue is whether the secured creditor retains the security right if the encumbered asset is transferred from the debtor to another person in the transaction that generates the proceeds (for a discussion of this issue, see A/CN.9/WG.VI/WP.2/Add.7, paras. 26-32).

40. The second issue concerns the creditor's rights with respect to the proceeds. A legal system governing security rights should provide clear answers to a number of questions (see paras. 41-47).

ii. Existence of rights in proceeds

41. The justification for a right in proceeds lies in the fact that, if the secured creditor does not obtain such a right, its rights in the encumbered assets could be defeated or reduced by a disposition of those assets. If the security right were extinguished once the encumbered assets are transferred to another person, it would not adequately protect the secured creditor against default and thus its value as a source of credit would diminish. This result, which would have a negative impact on the availability and the cost of credit, would be the same even if the security right in the original encumbered assets were to survive their disposition. The reason for this result lies in the possibility that a transfer of the encumbered assets may increase the difficulty in locating and obtaining possession, increase the cost of enforcement and reduce their value.

iii. Circumstances in which rights in proceeds may arise

42. A right in proceeds typically arises where the encumbered assets are disposed of (or leased or licensed). In systems that treat civil or natural fruits as proceeds, a right in such proceeds may arise even if no transaction takes place with respect to the encumbered assets (e.g. dividends arising from stocks).

iv. Personal or proprietary nature of rights in proceeds

43. If the secured creditor's right in proceeds is a proprietary right, the secured creditor will not suffer a loss by reason of a transaction or other event, since a proprietary right produces effects against third parties. On the other hand, granting the secured creditor a proprietary right in proceeds might result in frustrating legitimate expectations of parties who obtained security rights in those proceeds as original encumbered assets. However, in legal systems in which security rights are subject to filing, this matter may be easier to deal with. In such systems, potential financiers are forewarned about the potential existence of a security right in assets of their potential borrower (including proceeds of such assets) and can take the necessary steps to identify and trace proceeds.

v. Extent and time of identification of proceeds

44. [*The Working Group may wish to discuss the extent to which and the time when proceeds must be identifiable as resulting from the encumbered assets*.]

vi. Tracing of proceeds mingled with other assets

45. [*The Working Group may wish to discuss the issue of tracing of proceeds that have been intermingled with other assets*.]

vii. Basis of the rights in proceeds

46. In some legal systems, the law extends security rights to proceeds of encumbered assets and to proceeds of proceeds through default rules applicable in the absence of an agreement to the contrary. In other legal systems, such a statutory right in proceeds does not exist (for the reasons mentioned in para. 43), but parties may take security in all types of asset. In such systems, parties may be free to provide, for example, that security is created in inventory, receivables, negotiable instruments, securities and cash. In such a way, all these assets become original encumbered assets and not proceeds. In some of these legal systems, parties may extend by agreement certain quasi security rights (e.g. retention of title) to proceeds (see A/CN.9/WG.VI/WP.6/Add.2, paras. 34-42 and A/CN.9/WG.VI/WP.2/Add.7, paras. 51-59).

viii. Proceeds of proceeds

47. If there is a right in proceeds of encumbered assets, it should extend to proceeds of proceeds. If the secured creditor loses its right in the proceeds once they take another form, the secured creditor would be subject to the same credit risks as would be the case if there were no rights in proceeds (see para. 41).

3. Security agreement

a. Definition and functions

48. The security agreement between the creditor and the debtor or, in cases where security is provided by a third party, the grantor is one of the constitutive elements of a security right. An additional act is required in most, but not all, countries (see Section A.4). In some countries, the security agreement, accompanied by an additional act, produces proprietary effects against all parties (*erga omnes*). In those countries, quasi security devices, such as retention-of-title arrangements, produce proprietary effects *erga omnes* as of the time of the conclusion of the relevant agreement, which may be even oral. In other countries, the security agreement has proprietary effects only between the parties (*inter partes*), third-party effects being subject to an additional act.

49. 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). Such an agreement creates an obligation to create a security right, but has no proprietary consequences.

50. The security agreement fulfils several functions. First, in civil law countries it is the legal justification (*causa*) for granting the security right to the creditor. Second, the security agreement establishes the connection between the security right and the secured claim. Third, the security agreement generally regulates the relationship between the debtor (or a third party) as grantor of the security right in the encumbered assets and the secured creditor (for pre-default rights, see A/CN.9/WG.VI/WP.2/Add.8; for post-default rights, see and A/CN.9/WG.VI/WP.2/Add.9 and A/CN.9/WG.VI/WP.6/Add.5). While the security agreement may be a separate agreement, often it is contained in the underlying financing contract or other similar contract (e.g. contract of sale of goods on credit) between the debtor and the creditor.

b. Parties

51. In most cases, the security agreement is concluded between the debtor as grantor of the security right and the creditor as the secured party. Occasionally, if a third person grants the security for the benefit of the debtor, this person becomes a party to the agreement instead of the debtor. In the case of major loans granted by several creditors (especially in case of syndicated loans), a third party, acting as agent or trustee for the creditors, may hold security rights. None of these possible variations affects the substance of the security agreement.

c. Minimum contents

52. The security agreement should identify the parties and reasonably describe the obligation to be secured by the encumbered assets. Whether or not legislation lists these matters as the minimum contents of a security agreement, failure to deal with them in the security agreement may result in the security being null and void, unless the missing elements may be established through other means.

53. The parties may clarify in the security agreement additional matters, such as the duty of care on the part of the party in possession of the encumbered asset. In the absence of an agreement, default rules may apply to clarify the relationship between the parties (for pre-default

issues, see A/CN.9/WG.VI/WP.2/Add.8; for post-default issues, see A/CN.9/WG.VI/WP.2/Add.9 and A/CN.9/WG.VI/WP.6/Add.5).

d. Formalities

i. Written form and related requirements

54. Legal systems differ as to form requirements and their function. In particular with respect to written form, some legal systems require no writing at all while other legal systems require a simple writing, a signed writing or even a notarized writing or an equivalent court or other document (as is the case with enterprise mortgages). Normally, written form performs the function of a warning to the parties about the legal consequences of their agreement, of evidence of the agreement and of protection for third parties against fraudulent antedating of the security agreement.

55. Written form may also be a condition of validity (or effectiveness in the sense of producing proprietary effects) between the parties or a condition of enforceability as against third parties or of priority among competing claimants. It may also be a condition of obtaining possession of the encumbered assets or invoking a security agreement in the case of enforcement, execution or insolvency.

56. In some legal systems, a certification of the date by a public authority is required for possessory pledges, with the exception of small amount loans where proof even by way of witnesses is permitted. While such certification may address the problem of fraudulent antedating, it may raise the time and cost required for a transaction.

57. In other legal systems, a certified date or authentication of the security agreement is required for various types of non-possessory security (see, for example, articles 65, 70, 94 and 101 of the OHADA Act). At least in one country, such certification is required instead of publicity by registration. Where, however, registration is necessary, an additional certification of the date of the security agreement may not be required.

58. In the interest of saving time and cost, mandatory form requirements need to be kept to a minimum. Written form does not appear necessary as a condition of the validity (or effectiveness in the sense of producing proprietary effects) of the security agreement between the parties. However, with respect to third parties, a written security agreement may usefully serve evidentiary purposes and prevent fraudulent antedating, at least with respect to non-possessory security rights. A simple writing (which would need not to be signed by both parties and would include modern means of communication) should be sufficient. For enterprise mortgages or cases where the security agreement can serve as sufficient title for execution (see para. 55), a more formal document may be necessary. Alternatively, in such a case, no writing may be required but the secured creditor will have to bear the burden of establishing the contents and the date of the security agreement.

e. Effects

59. In some countries, in which property rights are only those that can be asserted against all parties (*erga omnes*), a fully effective security only comes into being upon conclusion of the security agreement and completion of an additional act

(delivery of possession, notification, registration or control; see paras. 61-70). There are two exceptions. In some countries, a retention-of-title clause is effective vis-à-vis third parties upon conclusion of the sales agreement in which it is contained. The other exception relates to an assignment of receivables by way of security, which in some countries is fully effective even without notification of the debtor of the receivable.

60. In other countries, a distinction is drawn between proprietary effects as between the parties to the security agreement and proprietary effects as against third parties. In those countries, the security comes already into existence upon conclusion of the security agreement (in writing) but only between the contracting parties (*inter partes*). An additional act is required for the security to take effect against third parties (see paras. 61-70).

4. Proprietary requirements

a. Ownership or right of disposition

61. In most legal systems, the grantor of the security (who normally is the debtor but may also be a third party) has to be the owner of the assets to be encumbered (see para. 16). In other legal systems, it is sufficient if the grantor has the power to dispose of the assets (but no ownership). With respect to future assets, it suffices if the grantor becomes the owner or obtains the power of disposition at a future time (see paras. 19-23).

62. Where the grantor does not have the ownership or the power to dispose of the assets, the question arises whether the secured creditor can nevertheless acquire the security right in good faith. In some legal systems, the creditor acquires the security right if the subjective good faith is supported by objective indicia of ownership. These elements include situations where the creditor has extended or is about to extend credit to the debtor, or the grantor is registered as the owner of the assets to be encumbered or holds them and transfers possession thereof to the creditor.

63. Legislation on this subject often addresses the related issue of the validity and the effectiveness of contractual restrictions on dispositions. In some countries, effect is given to such limitations in order to protect the interests of one or the other party to the agreement restricting dispositions. In other countries, no effect or only a limited effect is given to contractual restrictions of dispositions so as to preserve the grantor's freedom of disposition prevails, in particular if the person acquiring an asset is not aware of the contractual restriction.

64. The United Nations Assignment Convention takes a similar approach to support transferability of a receivable claim, which is in the interest of the economy as a whole. Under article 9 of the Convention, the assignment is effective despite a contractual restriction on assignment agreed upon between the assignor and the debtor. Mere knowledge of the existence of the restriction on the part of the assignee is not enough for the avoidance of the contract from which the assigned receivable arises. The effect of this provision is limited in two ways. First, its application is limited to trade receivables broadly defined; and second, the contractual restriction is effective as between the assignor and the debtor, and the debtor is free to claim damages from the assignor for breach of contract, if such a claim exists under law applicable outside the Convention. However, this claim may not be raised against the assignee by way of set-off (see article 18, paragraph 3).

65. This approach promotes receivables financing transactions since it relieves the assignee (i.e. the secured creditor) of the burden 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 receivables).

b. Transfer of possession, control, notification, publicity

66. The methods of producing proprietary effects as against third parties and, in those systems that allow the ranking of several security rights in the same assets, of establishing priority over competing claimants vary from country to country, and even within individual countries, according to the type of security right involved. There are four main methods of creating a security right that is effective as against all persons (and has priority over competing claimants).

i. Transfer of possession

67. The possessory pledge type of security right is created by agreement and transfer of possession of the asset to the creditor or to an agreed third person acting as the creditor's agent. In the case of a transfer of ownership for security purposes, possession may be fictitiously transferred to the creditor by way of an additional agreement of deposit or security. Such an agreement superimposes on the debtor's direct possession the creditor's indirect possession (*constitutum possessorium*). In the case of negotiable instruments, possession may also be transferred by delivery, with an endorsement, if necessary, under the rules governing negotiable instruments.

ii. Control

68. Security rights in certain intangibles (e.g. bank accounts) are created by agreement and transfer of control. Control may take the form of fictitious possession (e.g. if the bank has a security right in the debtor's account with the bank). It may also be reflected in the power of disposition (e.g. if the secured creditor, on the basis of an agreement with the debtor, can dispose of the debtor's account, without the debtor's further consent).

iii. Notification

69. Security rights in receivables may be created by agreement and notification of the debtor of the receivables. Such notification is regarded as an act of publicity. However, notification may not be a very effective way to publicize an assignment, since notification may be impossible (e.g. in the case of an assignment of future receivables) or very costly (e.g. in the case of a bulk assignment involving several debtors), or debtors may not provide any or accurate information to interested third parties.

iv. Publicity

70. Some form of publicity may be required in particular for the creation of non-possessory security rights in tangibles and intangibles. This publicity may take the form of registration of the security agreement and have constitutive effects. It may also take the form of registration of a limited amount of data and function as a

warning to third parties about the potential existence of a security right and as a basis for establishing priority among competing claimants (for details on the forms, functions and effects of publicity, see A/CN.9/WG.VI/WP.2/Add.5 and 6).

B. Summary and recommendations

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

[*Note to the Working Group: The Working Group may wish to consider whether any exceptions to these rules 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 a debtor*.]

72. 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 (see paras. 36-47)*.]

73. In principle, a security agreement creating a non-possessory security right should be in written form. No writing should be required for possessory security rights. Writing should include modern means of communications and need not be signed by both parties. It should identify the parties and reasonably describe the encumbered assets and the secured obligation. In situations where no formalities are required, the secured creditor should have the burden of proving both the terms of the security agreement and the date of creation of the security.

[*Note to the Working Group: The Working Group may also wish to consider whether further exceptions to the written form rule should be introduced*.]

74. An agreement between the secured creditor and the debtor (or other grantor) and transfer of possession of the encumbered asset to the secured creditor or to an agreed third party is necessary for the creation of a possessory security right.

75. An agreement (in written form; see para. 72) and some additional act (control, notification or publicity) should be sufficient for the creation of a non-possessory security right.

[*Note to the Working Group: The Working Group may wish to consider whether any exceptions to this general rule should be introduced. The Working Group may also wish to consider whether a distinction should be made between a security right that is valid or effective as between the parties thereto and a security right that is effective as against all third persons*.]