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Draft legislative guide on secured transactions

Report of the Secretary-General

Addendum

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VII. Pre-default rights and obligations of the parties

A. General remarks

1. Introduction

1. The requirements for a valid and enforceable security agreement should be minimal and easy to satisfy (see A/CN.9/WG.VI/WP.9/Add.1, paras. …). However, efficiency and predictability in secured transactions call for additional terms in the security agreement aimed at covering other aspects of the transaction. The parties themselves are encouraged to tailor the terms of the security agreement to fit their own needs and wishes. However, to fill gaps that may arise if the parties do not include additional terms, a modern secured transactions regime should include a set of suppletive rules detailing the parties' rights and obligations before default. An example of such a rule may be a rule that provides that revenues deriving from the encumbered assets may be retained by the secured creditor and increase the value of the encumbered asset or may be applied to the payment of the secured obligation in the case of default.

2. Comprehensive coverage in a secured transactions regime of the rights and obligations of the parties before default increase efficiency and predictability in several ways. It helps clarify the position of the parties by filling potential gaps with respect to issues not addressed by parties in the security agreement. Permitting the parties to define their relationship with the assistance of a set of suppletive rules also constitutes a core principle for an effective regime of secured transactions in personal property, or at least one of its most important corollaries (see A/CN.9/WG.VI/WP.6/Add.1, paras. 28 and 30). In this regard, the Guide pursues a policy shared by modern national legal systems (e.g. articles 2736-2742 of the Quebec Civil Code and article 9-207 to 9-210 of the Uniform Commercial Code), regional model laws (e.g. article 15 of the EBRD Model Law and article 33 of the Inter-American Model Law), and international conventions dealing with international sales (i.e. article 6 of the CISG) or some aspect of secured transactions in movable assets (e.g. article 11.1 of the United Nations Assignment Convention and article 16 of the Mobile Equipment Convention).

3. In addition, by allocating rights and obligations between secured creditor and grantor in the manner they themselves were most likely to agree, a set of suppletive norms helps to reduce transaction costs, eliminating the need for the parties to negotiate and draft new provisions already adequately covered by the rules. Also, clear suppletive rules provide direction to the parties and courts or arbitral tribunals, reducing potential disputes, related costs and inconsistent judgements. Finally, by offering a series of rules from which the parties may opt out, suppletive rules may be used as a drafting aid, providing a checklist of issues the parties may wish to address at the time of negotiation and conclusion of the security agreement.

4. Moreover, suppletive rules make it possible for the principle of party autonomy to operate to the full benefit of the parties. This is particularly important in long-term transactions or other transactions where the parties cannot anticipate everything or even have an interest in following a flexible approach, since requiring the parties to formalize all subsequent modifications and additions to their initial

agreement would impose significant compliance costs, which would ultimately be borne by the grantor.

5. There are three limitations to the scope of this Chapter. First, it does not deal with the terms required for a security right to exist (e.g. the minimum contents of the security agreement), since they fulfil a different function and are, therefore, addressed in Chapter IV (see A/CN.9/WG.VI/WP.6/Add.3, paras. 48-60). Second, this Chapter does not deal with the rights and obligations of the parties arising after default, since after default different policy issues arise that are addressed in Chapter VIII (see A/CN.9/WG.VI/WP.9/Add.5). And third, this Chapter is not intended to provide an exhaustive list of issues the parties may wish to address at the time they enter into contract negotiations, but offers, by necessity, only an indicative or non-exhaustive list of rights and obligations on which the parties freely negotiating a typical secured transaction are most likely to agree.

6. The initial discussion below is focused on two important policy issues. The first relates to the principle of party autonomy and the extent to which the parties should be free to fashion the terms of their security agreement (assuming that the agreement satisfies the substantive and formal requirements for the creation of a security right). The second relates to the type and number of suppletive rules to be included in modern secured transactions legislation, so as to encompass new and evolving forms of secured transactions. This Chapter concludes by outlining recommended suppletive rules.

2. Party autonomy

a. The principle

7. To the extent that consumer-protection or similar public policy considerations are not interfered with, party autonomy may be established as a cardinal principle governing the relationship of the parties to the security agreement prior to default. While party autonomy gives credit providers significant power in determining the content of the security agreement, it also results in providing grantors with wider access to credit at a lower cost.

b. Limitations

8. The secured creditor and the grantor should be mostly free to deal with their mutual contractual rights and obligations. However, such freedom extends to the contractual and not to the proprietary effects of the security agreement. Party autonomy applies to the parties to the security agreement (i.e. the secured creditor and the grantor), but should not affect the rights or obligations of persons not party to that agreement.

9. As it is not possible to foresee all the circumstances in which a security right may be required to secure the performance of an obligation, it is advisable to limit restrictions that hinder the ability of the parties to adapt a secured transaction to their own needs and circumstances. There must be, however, some restriction on party autonomy to prevent overreaching (for an example in the case of overcollateralization, see A/CN.9/WG.VI/WP.9/Add.1, paras. …). Those restrictions should be clearly defined and based on grounds of public policy (*ordre public*), and particularly the principle of good faith and fair dealing.

10. Aside from such reasonable restrictions, which each jurisdiction will determine on the basis of their own public policy criteria, the parties should be given wide flexibility to:

(i) Agree upon the terms of the security agreement;

(ii) Define the obligation to be secured and the events triggering its default; and

(iii) Determine what the grantor can and can not do with the encumbered assets.

3. Suppletive rules

a. Meaning

11. The rules included in this Chapter are meant to apply only if the parties have not agreed otherwise. They apply automatically in the absence of evidence that the parties intended to exclude them. The conceptual vocabulary used to identify rules "subject to contrary agreement between the parties" varies from country to country (e.g. *jus dispositivum, lois supplétives, normas supletorias*, non-mandatory rules, default rules). Whatever terminology is used to formulate these rules, it should clarify that the rules apply and are enforceable only on the condition that the parties did not agree otherwise.

12. The suppletive rules discussed in this Chapter cover only the most regular incidents arising during the course of a secured transaction, i.e. the rights and obligations that the legislator fairly infers the parties would have most likely agreed upon but failed to address expressly in the security agreement.

b. Policy objectives

13. All suppletive rules should be based on policy objectives, such as reasonable allocation of responsibility for caring for the encumbered asset and preservation of pre-default value. Additional terms in the security agreement, aimed at enhancing the protection of secured lenders or grantors, are better left to the parties' initiative. For example, the parties could specify in their agreement the law governing their mutual rights and obligations, or agree that the grantor would deposit any insurance proceeds obtained because of the loss of the encumbered asset in a given deposit account. These are mere illustrations of the many incidents, for which the contracting parties typically provide expressly in their agreement.

14. Suppletive rules should reflect the needs and practices of each jurisdiction. Yet, most jurisdictions are likely to agree on the advantages of adopting rules that are conducive to promoting access to credit at a lower cost and to encouraging responsible behaviour on the part of those having control and custody of encumbered assets. For example, most jurisdictions would agree with a suppletive rule that would provide for the right of the secured creditor to be reimbursed for reasonable expenses incurred to preserve the encumbered asset.

c. Types of suppletive rules

15. A distinction may be drawn between the rights and obligations of a secured creditor in possession of the encumbered assets (possessory security), those

pertaining to the grantor in possession of the encumbered assets (non-possessory security), and those that are common to both possessory and non-possessory security rights.

i. Possessory security rights

16. In the context of possessory security rights, the suppletive rules should, at the very least, encourage the secured creditor to preserve the value of the encumbered assets, especially if those assets represent income-producing property. The following are among the most important duties and rights conferred on a secured creditor in possession of the encumbered assets.

(a) Duty of care

17. Responsible behaviour on the part of the secured creditor in possession may be encouraged by the imposition of an obligation to take reasonable care of the encumbered asset. While the parties may not exclude the duty of care or release the secured creditor from liability for its breach, they may vary the extent and the manner in which the duty of care may be exercised. The scope of the duty of care varies depending on the nature of the assets. In the case of tangible assets, the duty of care would go to the physical preservation of the assets (as to intangible assets, see paras. 19 and 34).

18. Depending on the circumstances, the duty of care may be discharged in different ways. In some cases, it may be unreasonable to expect the grantor to oversee the encumbered asset and more appropriate for the secured creditor in possession to carry out the duty of care. In other cases, it may be enough for the secured creditor to notify the grantor, who may be in a better position to take the steps necessary to preserve the asset (but not in the grantor's premises as return of the encumbered asset may result in the extinction of the security right). As it is not possible to detail in one suppletive rule the different meanings that the duty of care may take in different circumstances, it is advisable to draft such rule in broad terms.

(b) Duty to take further steps to preserve the grantor's rights in intangibles

19. If the encumbered asset consists of a right to payment of money embodied in a negotiable instrument, the duty of care is not limited to the physical preservation of the document embodying such right to payment. It also extends to the obligation to take necessary steps to maintain or preserve the grantor's rights against prior parties bound under the negotiable instrument. Those steps may include, for example, presentation of the instrument, protest, if required, and notice of dishonour. It is also incumbent upon a secured creditor in possession of an encumbered asset in the form of a negotiable instrument to preserve the grantor's rights by taking steps against persons secondarily liable under the instrument (e.g. guarantors).

(c) Right to make reasonable use of the encumbered asset

20. The secured creditor should be allowed to make use of or operate the encumbered asset for the purpose of its preservation and maintenance, although always in a manner and an extent that is reasonable.

(d) Duty to keep the encumbered assets identifiable

21. If the encumbered assets are of a non-fungible nature, the secured creditor must keep tangible assets in an identifiable form and not commingle such assets with other assets. If the encumbered assets are fungible and commingled with other assets of the same nature, then the secured creditor's duty to keep the encumbered assets identifiable becomes a duty to keep assets of the same quantity, quality and value as the assets originally encumbered.

(e) Duty to allow inspection by grantor

22. An additional obligation of the secured creditor in possession is to allow the grantor to inspect the encumbered assets at reasonable times.

(f) Right to retain any proceeds or civil fruits as additional security

23. The secured creditor should be able to hold monetary or non-monetary proceeds or "civil fruits" (see A/CN.9/WG.VI/WP.6/Add.3, paras. 36-37) derived from the encumbered asset. Monetary proceeds or civil fruits may be applied to the payment of the secured obligation, unless otherwise agreed by the parties in the security agreement.

(g) Right to assign the secured obligation and the security right

24. The secured creditor may assign the secured obligation and the security right (in some jurisdictions even despite contractual limitations on assignment; see article 9 (1) of the United Nations Assignment Convention). In exceptional cases, security rights may be assigned separately from the obligation they secure (e.g. in the case of a transfer of a security right of a parent corporation in the assets of a subsidiary to a financing institution for the purpose of ensuring new credit to the subsidiary).

(h) Right to "repledge" the encumbered asset

25. In some jurisdictions, the secured creditor may create a security right in the encumbered asset as security for a debt ("repledge the encumbered asset") as long as the grantor's right to obtain the assets upon payment of the secured obligation is not impaired. In other jurisdictions, the secured creditor in possession is not entitled to repledge the encumbered asset, even if it does so on terms that do not impair the grantor's right to get the asset back upon performance of the secured obligation. In the context of secured transactions relating to investment property, however, the secured creditor's right to repledge is a matter of common practice (security rights in investment property, however, are beyond the scope of this Guide).

(i) Right to insure against loss or damage of the encumbered asset

26. The risk of loss or deterioration of the encumbered assets remains on the grantor despite the creation of a security right (in most legal systems the grantor retains a property right in the encumbered asset). Yet, it is in the interest of the secured creditor to keep the encumbered asset insured in full. Therefore, the secured creditor should be entitled to contract insurance on behalf of the grantor and be reimbursed for that expense.

(j) Right to pay taxes on behalf of the grantor

27. Taxes assessed against the encumbered assets also fall under the responsibility of the grantor. However, a secured creditor should be entitled to pay those taxes on the grantor's behalf to protect its security right in the assets. Such payment should be regarded as a reasonable charge incurred in the preservation of the encumbered asset for which the secured creditor should be entitled to reimbursement.

(k) Right to be reimbursed for reasonable expenses

28. Expenses that are necessary for the custody and preservation of the encumbered assets while in the possession of the secured creditor should be borne by the grantor. If those expenses are incurred by the secured creditor in possession of the encumbered asset and pursuant to its duty of care, the secured creditor has the right to be reimbursed by the grantor for those expenses. Insurance premiums (see para. 26) and tax payments (see para. 27) are examples of reasonable expenses chargeable to the grantor and for which the secured creditor is entitled to reimbursement.

29. The security agreement may provide for other ways of allocating the expenses associated with the preservation and care of the encumbered assets. Moreover, the security agreement may provide for other types of expenses, which are incurred to protect the secured creditor's own interest in the encumbered assets rather than that of the grantor. Even if those expenses are reasonable, they should not be chargeable to the grantor as a matter of suppletive law. Payment for those expenses may, however, be allocated to the grantor if so agreed in the security agreement.

(l) Duty to return the encumbered asset

30. Upon full payment of the secured obligation, the secured creditor in possession must return the encumbered asset to the grantor. As the secured creditor cannot contract out of this obligation, it is normally part of a mandatory rather than suppletive rule.

ii. Non-possessory security

31. A key policy objective of an effective secured transactions regime is to encourage responsible behaviour by the grantor who remains in possession of the encumbered assets (see A/CN.9/WG.VI/WP.6/Add.1, para. 33). Accordingly, the policies underlying the suppletive rules for non-possessory security are aimed at maximizing the economic potential of the grantor's assets (see A/CN.9/WG.VI/WP.6/Add.1, para. 28). Encouraging the economic utilization of the grantor's assets facilitates the generation of revenue for the grantor. Maintaining the pre-default value of the encumbered assets is consistent with the objective of maximizing the realization value of those assets for the benefit of the secured creditor.

(a) Duty to allow the secured creditor to inspect

32. The secured creditor should have the right to monitor the conditions in which the encumbered asset is kept by the grantor in possession. To this effect, the grantor should be bound to allow the secured creditor to inspect the encumbered assets at all reasonable times.

(b) Duty to keep the encumbered assets properly insured and to pay taxes

33. The duty of care allocated to the grantor in possession includes keeping the encumbered asset properly insured and ensuring that the property taxes are paid. If these expenses are incurred by the secured creditor, it has the right to be reimbursed by the grantor whose obligation to reimburse is secured by the security right (see paras. 26 and 27).

(c) Duty to take steps to preserve rights in the encumbered assets

34. In the case of intangible encumbered assets, such as the grantor's right to payment in the form of receivables (e.g. deposit accounts, royalties or rights on account of patents, copyrights and trademarks), the main component of the grantor's obligation of care is the taking of necessary steps to preserve those rights, regardless of whether or not they are represented in a negotiable instrument (as to rights represented in a negotiable instrument, see para. 19).

(d) Right to receive proceeds or "civil fruits"

35. Any increase in value or profit deriving from the encumbered assets in the grantor's possession, regardless of whether those additional assets are regarded as civil or natural fruits or proceeds (for a discussion of this issue, see A/CN.9/WG.VI/WP.9/Add.1, paras. …), is automatically subject to the security right held by the secured creditor, unless otherwise agreed (see para. 23).

(e) Duty to account and to keep adequate records

36. If the encumbered assets consist of income-producing property in possession of the grantor, to the extent that the security right extends to the income or revenues generated by the asset, the grantor's duties may include maintaining adequate records and the reasonable rendering of accounts regarding the disposition and the handling of the proceeds derived from the encumbered assets.

(f) Right to use, dispose, mix, process and commingle the encumbered assets

37. The grantor in possession is entitled to use, mix, process and commingle the encumbered assets with other assets. In principle, the grantor should not be entitled to dispose of the encumbered assets without authorization of the secured creditor. By way of exception, however, the grantor may dispose of the encumbered assets as long as the disposal is in the ordinary course of the grantor's business (see A/CN.9/WG.VI/WP.9/Add. 3, paras. …).

38. In the case of disposition of the encumbered assets resulting in the extinction of the security right over those assets, the security right may extend to the proceeds (for a discussion of this issue, see A/CN.9/WG.VI/WP.6/Add.3, paras. 41-47).

(g) Right to grant another security right in the same asset

39. The grantor should be entitled to confer a subsequent security right over an already encumbered asset.

(h) Duty of secured creditor to cancel registration or to take other steps

40. Upon full performance of the secured obligation, the secured creditor must release the encumbered asset from the security right and request the cancellation of the registration of the security right or take any other steps conducive to giving notice that the grantor's assets are no longer subject to a security right (as the secured creditor may not contract out of this obligation, it is normally part of mandatory rather than suppletive law).

iii. Possessory and non-possessory security

(a) Duty of care

41. If the encumbered asset is a tangible asset, the duty of care relates mainly to the preservation of the asset (see para. 17). If the encumbered asset is an intangible, the secured creditor's duty of care extends to both the physical preservation of any instrument and to taking the necessary steps to defend and enforce the right to payment incorporated in the instrument (see also paras. 19 and 34).

(b) Grantor's duty to make up for unexpected devaluation

42. If the value of the encumbered assets were to decrease significantly for reasons that were unforeseeable at the time of the conclusion of the security agreement, the grantor may have to offer additional security to make up for the unexpected and significant decrease in value.

43. As to expected deterioration of the value of the encumbered asset due to the passage of time or market conditions, the parties to the security agreement may wish to provide that, if such deterioration were to reach a significant mark, the grantor should offer additional security or the secured creditor may consider this as an event of default.

(c) Right to assign the security right together with the secured obligation

44. A secured creditor may freely assign the secured obligation in which case the security right normally follows (see, for example, article 10 of the United Nations Assignment Convention; in some cases, the secured creditor may assign the security right without the secured obligation; see para. 24). After such an assignment, the assignee-transferee inherits all the rights and obligations of the original secured creditor.

(d) Secured creditor's duty to return the encumbered asset or otherwise release the security right

45. Upon full performance of the secured obligation, the secured creditor in possession must return the encumbered asset to the grantor (see para. 30). In the case of non-possessory security registered in a public registry, the secured creditor has to request the cancellation of the security right or to file a notice of release of the encumbered asset (see para. 40).

B. Summary and recommendations

46. The suppletive rules included in this Chapter seek to clarify the pre-default rights and obligations of the parties to the security agreement. These rules only pertain to the contractual rights and obligations of the parties prior to default, to the exclusion of the proprietary effects of the security agreement and the relationship between the parties after default.

47. The rules are permissive rather than mandatory, so that the expression "unless otherwise agreed" should be read as a preamble to each of the rights and duties allocated to the parties under these rules. A corollary of the permissive nature of these rules is that the parties may waive or vary the rights and obligations allocated to them, unless such waiver is against public policy or in conflict with an overriding principle of good faith and fair dealing.

48. In principle, the parties to a secured transaction should be free to agree on the terms of their relationship subject to the limits imposed by public policy (*ordre public*) and the protection of third parties. For example, the secured creditor in possession cannot contract out of the duty to return the encumbered asset to the grantor upon payment of the secured obligation (see paras. 30, 40 and 45).

49. A secured creditor in possession of the encumbered asset should care for, preserve and maintain the asset in good condition. The secured creditor is also bound to undertake all necessary repairs to keep the encumbered asset in such condition. In the case of tangible encumbered assets, the secured creditor should keep those assets properly identifiable. If those assets are fungible, the duty of care extends to an obligation to preserve encumbered assets of the same quantity, quality and value.

50. Where the encumbered asset consists of the grantor's right to the payment of money, whether or not that right is embodied in an instrument, the obligation of care on the part of the secured creditor should include the duty to preserve the grantor's rights against persons secondarily liable.

51. The secured creditor in possession should allow the grantor to inspect the encumbered asset at all reasonable times. Upon full satisfaction of the secured obligation, the secured creditor should return the encumbered asset to the grantor.

52. The secured creditor in possession may be entitled to retain as additional security any increase in value or profit deriving from the encumbered asset. In the case of cash proceeds, the secured creditor may apply them to the payment of the secured obligation or remit them to the grantor.

53. Except in limited circumstances, the secured creditor may not create a security right in the encumbered assets in its possession.

54. Reasonable expenses incurred by the secured creditor while discharging the obligation of custody and care (including the cost of insurance and payment of taxes) must be reimbursed to the secured creditor. The secured creditor's right to be reimbursed for those expenses should also be secured by the encumbered asset.

55. In the context of non-possessory security, the grantor who remains in possession of the encumbered assets should also be bound by a duty of custody and

preservation. In fulfilling this duty, the grantor has to bear the necessary expenses, such as insurance premiums, taxes and other charges.

56. The grantor in possession should be entitled to use, mix, process and commingle the encumbered assets with other assets, as well as to dispose of the encumbered assets in the ordinary course of its business. The security right may continue in the proceeds or "civil fruits" deriving from the encumbered asset.

57. The grantor in possession may grant a subsequent security right in the encumbered assets.

58. The grantor in possession should allow the secured creditor to monitor the encumbered assets at reasonable times. In the case of income-producing encumbered assets, it is the grantor's duty to keep reasonable records detailing the ways of disposing of encumbered assets and handling the proceeds.

59. If the encumbered assets consist of intangibles, the grantor's obligation of care extends to asserting or defending the grantor's right to be paid or to taking the necessary steps to collect the debt owed to the grantor.

60. Upon performance in full of the secured obligation, it is the duty of the secured creditor to request the cancellation of the registration of the security right or to take any other step aimed at giving notice to third parties that the encumbered assets are no longer encumbered.