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Draft legislative guide on secured transactions

Report of the Secretary-General

Contents

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X. Conflict of laws

A. General remarks

1. Introduction

a. Purpose of conflict-of-laws rules

1. This chapter discusses the rules for determining the law applicable to the creation of a security right as between the grantor and the secured creditor, effectiveness against third parties ("third-party effectiveness"), priority and enforcement. These rules are generally referred to as conflict-of-laws rules and also determine the territorial scope of the substantive rules envisaged in the Guide (i.e. if and when the substantive rules of the State enacting the regime envisaged in the Guide apply). For example, if a State has enacted the substantive law rules envisaged in the Guide relating to the priority of a security right, these rules will apply to a priority contest arising in the enacting State only to the extent that the conflict-of-laws rule on priority issues points to the laws of that State. Should the conflict rule provide that the law governing priority is that of another State, then the relative priority of competing claimants will be determined in accordance with the law of that other State, and not pursuant to the substantive priority rules of the enacting State.

2. After a security right has become effective, a change might occur in the connecting factor for the choice of the applicable law. For instance, if the third-party effectiveness of a security right in tangible goods located in State A is governed by the law of the location of the goods, the question arises as to what happens if those goods are subsequently moved to State B (whose conflict rules also provide that the location of the goods governs the third-party effectiveness of security rights over tangible property). One alternative would be for the security to continue to be effective in State B without the need to take any further step in State B. Another alternative would be for new security to be obtained under the laws of State B. Yet another alternative would be for the secured creditor's pre-existing right to be preserved subject to the fulfilment in State B of certain formalities within a certain period of time (e.g. 30 days after the goods have been brought into State B). These issues are addressed by the conflict-of-law rules of some legal systems. This chapter proposes in this regard a general rule based on the latter alternative.

3. Conflict-of-laws rules should reflect the objectives of an efficient secured transactions regime. Applied to the present chapter, this means that the law applicable to the property aspects of a security right should be capable of easy determination: certainty is a key objective in the elaboration of rules affecting secured transactions both at the substantive and conflict-of-laws levels. Another objective is predictability. As illustrated by the question in the preceding paragraph, the conflict-of-laws rules should permit the preservation of a security right acquired under the laws of State A if a subsequent change in the connecting factor for the selection of the applicable law results in the security right becoming subject to the laws of State B. A third key objective of a good conflict-of-laws system is that the relevant rules must reflect the reasonable expectations of interested parties (creditor, grantor, debtor and third parties). According to many, in order to achieve this result,

the law applicable to a security right should have some connection to the factual situation that will be governed by such law.

4. Use of the Guide (including this chapter) in developing secured transactions laws will help reduce the risks and costs resulting from differences between current conflict-of-laws rules. In a secured transaction, the secured creditor normally wants to ensure that its rights will be recognized in all States where enforcement might take place (including in a jurisdiction administering the insolvency of the grantor). If those States have different conflict-of-laws rules in relation to the same type of encumbered assets, the creditor will need to comply with more than one regime in order to be fully protected. A benefit of different States having harmonized conflict-of-laws rules is that a creditor can rely on one single law to determine the priority status of its security in all such States. This is one of the goals achieved in respect of receivables by the United Nations Assignment Convention and in respect of indirectly-held securities by the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary.

5. It is worth noting that conflict-of-laws rules would be necessary even if all States had harmonized their secured transactions laws. There would remain instances where the parties would have to identify the State whose requirements will apply. For example, if the laws of all States provided that a non-possessory right is made effective against third parties by filing in a public registry, one would still need to know in which State's registry the filing must be made.

b. Scope of conflict-of-laws rules

6. This chapter does not define the security rights to which the conflict-of-laws rules will apply. Normally, the characterization of a right as a security right for conflict-of-laws purposes will reflect the substantive security rights law in a jurisdiction. In principle, a court will use its own law whenever it is required to characterize an issue for the purpose of selecting the appropriate conflict-of-laws rule. The question arises, however, as to whether the conflict-of-laws rules for security rights should also apply to other transactions that are functionally similar to security, even if they are not covered by a secured transactions regime. To the extent that title reservation agreements, financial leases, consignments and other similar transactions would not be governed by the substantive law provisions governing secured transactions, a State might nonetheless subject these devices to the conflict-of-laws rules applicable to secured transactions.

7. A similar issue arises in respect of certain transfers not made for security purposes, where it is desirable that the applicable law for creation as between the parties, third party effectiveness and priority be the same as for a security right over the same category of property. An example is found in the United Nations Assignment Convention, which (including its conflict-of-laws rules) applies to outright transfers of receivables as well as to security rights in receivables (see art. 2 (a)). This policy choice is motivated, inter alia, by the necessity of referring to one single law to determine priority between competing claimants with a right in the same receivable. In the event of a priority dispute between a purchaser of a receivable and a creditor holding security in the same receivable, it would be more difficult (and sometimes impossible) to determine who is entitled to priority if the priority of the purchaser were governed by the laws of State A but the priority of the secured creditor were governed by the laws of State B.

8. Whatever decision a jurisdiction makes on the range of transactions covered by the conflict-of-laws rules, the scope of the rules will be confined to the property aspects of these transactions. Thus, a rule on the law applicable to the creation of a security right only determines what law governs the requirements to be met for a property right to be created in the encumbered assets. The rule would not apply to the personal obligations of the parties under their contract. Personal obligations, in most legal systems, subject to certain limitations, are governed by the law chosen by the parties in their agreement or, in the absence of such a choice, either by the law of the State with which the security agreement is most closely connected or by the law governing the security agreement.

9. A corollary to recognizing party autonomy with respect to the personal obligations of the parties is that the conflict-of-laws rules applicable to the property aspects of secured transactions are matters that are outside the domain of freedom of contract. For instance, the grantor and the secured creditor are normally not permitted to select the law applicable to priority, since this could not only affect the rights of third parties, but also result in a priority contest between two competing secured creditors being subject to two different laws leading to opposite results.

10. It is worth noting that the conflict-of-laws rules of many legal systems now provide that reference to the law of another State as the law governing an issue refers to the law applicable in that State to the exclusion of its conflict rules. The doctrine of *renvoi* is excluded, for sake of predictability and also because *renvoi* may run contrary to the expectations of the parties.

2. Conflict-of-laws rules for creation as between the parties, third-party effectiveness and priority

11. The determination of the extent of the rights conferred by a security right generally requires a three-step analysis:

(a) The first issue is whether the security has been created as between the parties (for matters covered by the notion of creation as between the parties, see chapter IV);

(b) The second issue is whether the security is effective against third parties (for matters covered by the notion of third-party effectiveness, see chapter V); and

(c) The third issue is what is the priority ranking of the secured creditor as against a competing claimant, such as another creditor or an administrator in the insolvency of the grantor (for matters covered by the notion of priority, see chapter VI).

[*Note to the Working Group: The Working Group may wish to consider whether there should be a conflict rule on the issue of the extinction of a security right or whether such issue falls outside the scope of the conflict-of-laws rules applicable to security rights.*]

12. Not all legal systems make specific conceptual distinctions among these issues. In some legal systems, the fact that a property right has been validly created necessarily implies that the right is effective against third parties. Moreover, legal systems that clearly distinguish among the three issues do not always establish separate substantive rules on each issue. For example, in the case of a possessory pledge complying with the requirements for the *in rem* validity of a security right of

this type generally results in the security being effective against third parties without any need for further action.

13. The key question is whether one single conflict-of-laws rule should apply to all three issues. The alternative is to allow for more flexibility, where it may be more appropriate that the law applicable to third-party effectiveness or priority be different from that governing the creation of the right. Policy considerations, such as simplicity and certainty, favour adopting one rule for creation as between the parties, third-party effectiveness and priority. As noted above, the distinction among these issues is not always made or understood in the same manner in all legal systems, with the result that providing different conflict-of-laws rules on these issues may complicate the analysis or give rise to uncertainty. There are, however, instances where selecting a different law for priority issues would better take into account the interests of third parties such as persons holding non-consensual security.

14. Another important question is, whether on any given issue (i.e. creation as between the parties, third party effectiveness or priority) the relevant conflict-of-laws rule should be the same for tangible and intangible property. A positive answer to that question would favour a rule based on the law of the location of the grantor. The alternative would be the place where the encumbered asset is held (*lex situs*), which would, however, be inconsistent in respect of receivables with the United Nations Assignment Convention (article 22 of which refers to the law of the State in which the assignor, i.e. the grantor, is located).

15. Consistency with the United Nations Assignment Convention would also dictate defining the location of the grantor in the same way as in that Convention. Under the Convention, the grantor's location is its place of business or if the grantor has places of business in more than one State, the place where the central administration of the grantor is exercised. If the grantor has no place of business, reference is then made to the grantor's habitual residence (see article 5 (h)).

16. Simplicity and certainty considerations support the adoption of the same conflict-of-laws rule (e.g. the law of the grantor's location) for both tangible and intangible property, especially if the same law applies to creation as between the parties, third party effectiveness and priority. Following this approach, one single enquiry would suffice to ascertain the extent of the security rights encumbering all assets of a grantor. There would also be no need for guidance in the event of a change in the location of encumbered assets or to distinguish between the law applicable to possessory and non-possessory rights (and to determine which prevails in a case where a possessory security right governed by the law of State A competes with a non-possessory security right in the same property governed by the law of State B).

17. Not all jurisdictions, however, regard the law of the location of the grantor as sufficiently connected to security rights in tangible property (for "non-mobile" goods at least). Moreover, the law governing a secured transaction would need to be same as the law governing a sale of the same assets. This means that acceptance of the grantor's law for every type of security right would be workable only if jurisdictions, generally, were prepared to accept that rule for all transfers.

18. In addition, it is almost universally accepted that a possessory right should be governed by the law of the place where the property is held, so that adopting the law

of the grantor for possessory rights would run against the reasonable expectations of non-sophisticated creditors. Accordingly, even if the law of the grantor's location were to be the general rule, an exception would need to be made for possessory security rights.

19. As the applicable conflict rules might be different depending on the tangible or intangible character of the assets or the possessory or non-possessory nature of the security, the question arises as to which conflict rule is appropriate if intangible property is capable of being the subject of a possessory security right. In this regard, most legal systems assimilate certain categories of intangibles incorporated in a document (such as negotiable instruments and certificated securities) to tangible property, thereby recognizing that such assets may be pledged by delivering the document to the creditor. The pledge would then be governed by the law of the State where the document is held.

20. A related issue arises where goods are represented by a negotiable document of title (such as a bill of lading). It is generally accepted that a negotiable document of title is also assimilated to tangible property and may be the subject of a possessory pledge. The law of the location of the document (and not of the goods covered thereby) would then govern the pledge. The question arises, however, what law would apply to resolve a priority contest between a pledgee of a document of title and another creditor to whom the debtor might have granted a non-possessory security right in the goods themselves, if the document and the goods are not held in the same State. In such a case, the conflict-of-laws rules should accord precedence to the law governing the pledge, on the basis that this solution would better reflect the legitimate expectations of interested parties.

[*Note to the Working Group: The scope of the law envisaged by this Guide is focused on commercial goods, equipment and trade receivables. If the Working Group decides to cover other categories of intangible property, such as non-trade receivables, bank deposits and letters of credit, it may wish to consider whether there should be any special conflict rules for these types of asset.*]

3. Conflict-of-laws rules for security rights in proceeds

21. Simplicity and certainty considerations would dictate applying to proceeds the same conflict rules as those governing the creation as between the parties, third-party effectiveness and priority of a security right directly obtained over assets that are of the same type of property as the proceeds. For instance, if a creditor claims rights in receivables as proceeds from the sale of inventory previously subject to a security right in its favour, the creditor's entitlement to the receivables should be determined using the same law as would have been applicable to a security right directly obtained in the receivables as original encumbered assets. In this example, if the law of State B were to govern a security right originally granted in receivables, that law would also determine whether the creditor is entitled to the receivables as proceeds from inventory, even if the creditor's security right over the inventory was governed by the law of State A. The third-party effectiveness and the priority of the creditor's entitlement to the receivables (as proceeds from inventory) would also be governed by the law of State B.

22. It is arguable, however, that the above solution should be subject to an exception, namely, that the creation as between the parties of a security right in proceeds should be governed by the law that was applicable to the creation as

between the parties of the security right in the original encumbered assets from which the proceeds arose. This would meet the expectations of a creditor obtaining a security right in inventory under a domestic law providing that such security right automatically extends to proceeds. Under this approach, the question of whether a security right extends to proceeds would be governed by the law applicable to the creation as between the parties of a right in the original encumbered assets from which the proceeds arose, while the third-party effectiveness and priority of an entitlement to proceeds would be subject to the law that would have been applicable to such issues if the proceeds had been original encumbered assets.

4. Effect of a subsequent change in the connecting factor

23. Whatever connecting factor is retained for determining the most appropriate conflict-of-laws rule for any given issue, there might occur a change in the relevant factor after a security right has been created. For example, where the applicable law is that of the jurisdiction where the grantor has its head office, the grantor might later relocate its head office to another jurisdiction. Similarly, where the applicable law would be the law of the jurisdiction where the encumbered assets were located, the assets might be moved to another jurisdiction.

24. If these issues are not dealt with specifically, an implicit rule might be drawn. The general conflict-of-laws rules on creation as between the parties, third-party effectiveness and priority might be construed to mean that, in the event of a change in the relevant connecting factor, the original governing law continues to apply to creation issues (because they arose before the change, while the subsequent governing law would apply to events occurring thereafter that raise third-party effectiveness or priority issues. For instance, in a situation where the law applicable to the third-party effectiveness of a security right is that of the grantor's location, the effectiveness of the right against the insolvency administrator of the grantor would be determined using the law of the State of the new location of the grantor at the time of commencement of the insolvency proceedings.

25. The silence of the law on these matters might, however, give rise to other interpretations. For example, one interpretation might be that the subsequent governing law also governs creation as between the parties in the event of a priority dispute occurring after the change (on the basis that third parties dealing with the grantor are entitled to determine the applicable law for all issues relying on the actual connecting factor, being the connecting factor in effect at the time of their dealings).

26. Providing guidance on these issues would appear to be necessary to avoid uncertainty, in particular where the connecting factor changes from a State that has not enacted a law based on the recommendations of this Guide to a State that has enacted such a law.

27. Related issues arise with respect to security rights in goods in transit and export goods. Some legal systems provide that a security right over such goods (which can only be non-possessory as possession is understood under the Guide as actual, not fictive, possession) may be created as between the parties and made effective against third parties under the law of the place of destination if they reach that place within a specified time limit. With respect to goods intended to be exported, an alternative would be to require that they leave the enacting State within

a specified time limit. However, a special rule on goods in transit and export goods should not prevent the creditor from also establishing its right pursuant to the law of the actual location of the goods in order to obtain priority under that law in the event the goods were to remain in that location.

5. Conflict-of-laws rules for enforcement issues

28. Where a security right is created and made effective against third parties under the law of one State, but is sought to be enforced in another State, an issue arises regarding what remedies are available to the secured creditor. This is of great practical importance where the substantive enforcement rules of the two States are significantly different. For example, the law governing the security right could allow enforcement by the secured creditor without prior recourse to the judicial system unless there is a breach of peace, while the law of the place of enforcement might require judicial intervention. Each of the possible solutions to this issue entails advantages and disadvantages.

29. One option is to subject enforcement remedies to the law of the place of enforcement, i.e. the law of the forum (*lex fori*). The policy reasons in favour of this rule include that:

(a) The law of remedies would coincide with the law generally applicable to procedural issues;

(b) The law of remedies would, in many instances, coincide with the location of the property being the object of the enforcement (and could also coincide with the law governing priority if the conflict-of-laws rules of the relevant State point to such location for priority issues);

(c) The requirements would be the same for all creditors intending to exercise rights against the assets of a grantor, irrespective of whether such rights are domestic or foreign in origin.

30. On the other hand, the *lex fori* might not give effect to the intention of the parties. The parties' expectations may be that their respective rights and obligations in an enforcement situation will be those provided by the law under which the priority of the security right will be determined. For example, if extra-judicial enforcement is permitted under the law governing the priority of the security right, it may also be available to the secured creditor in the State where the latter has to enforce its security right, even if it is not generally allowed under the domestic law of that State. Another reason for applying the law governing priority to substantive enforcement matters is that such matters are closely connected with priority issues (e.g. the manner in which a secured creditor will realize on its security may impact on the rights of competing claimants).

31. An approach referring enforcement issues to the law governing the priority of a security right may have another benefit. As the law governing priority is often the same law as the law governing the creation of a security right as between the parties, the end result would be that creation as between the parties, priority and enforcement issues would often be subject to the same law.

32. A third option is to adopt a rule whereby the law governing the contractual relationship of the parties would also govern enforcement matters. This would often correspond to their expectations and, in many instances, would also coincide with

the law applicable to the creation of the security right as between the parties since that law is often selected as also being the law of the contract. However, under this approach, parties would then be free to select, for enforcement issues, a law other than the law of the forum or the law governing creation as between the parties, third-party effectiveness and priority. This solution would be disadvantageous to third parties that might have no means to ascertain the nature of the remedies that could be exercised by a secured creditor against the property of their common debtor.

33. Therefore, referring enforcement issues to the law governing the contractual relationship of the parties would necessitate exceptions designed to take into account the interests of third parties, as well as the mandatory rules of the forum, or of the law governing creation as between the parties, third-party effectiveness and priority.

34. The foregoing discussion relates to the substantive aspects of enforcement. Procedural matters would in any case need to be governed by the law of the State where enforcement takes place. The question arises, then, as to the distinction to be made between substantive and procedural enforcement matters. Although a Court would use its own law to determine what is substantive and what is procedural, the following are examples of issues generally considered to be substantive: the nature and extent of the remedies available to the creditor to realize the encumbered assets, whether such remedies (or some of them) may be exercised without judicial process, the conditions to be met for the secured creditor to be entitled to obtain possession and dispose of the assets (or to cause the assets to be judicially realized), the power of the secured creditor to collect receivables that are encumbered assets and the obligations of the secured creditor to the other creditors of the grantor.

6. The impact of insolvency on conflict-of-laws rules

35. As pointed out in the Insolvency chapter, subject to avoidance actions, a security right effective against the grantor and third parties outside of insolvency should continue to be effective in insolvency proceedings. Similarly, the commencement of insolvency proceedings should not displace the conflict-of-laws rules applicable to the creation as between the parties, third-party effectiveness and, subject to some exceptions (e.g. with respect to privileged claims), the priority of a security right. However, all aspects of the enforcement of a security right in insolvency proceedings should be subject to the law governing the insolvency proceedings (for the principle and limited exceptions, see recommendations 30-34 of the UNCITRAL Legislative Guide on Insolvency Law).

B. Recommendations

[*Note to the Working Group: As documents A/CN.9/WG.VI/WP.16 and Add.1 include a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations on conflict of laws are not reproduced here. Once the recommendations are finalized, the Working Group may wish to consider whether they should be reproduced at the end of each chapter or in an appendix at the end of the guide or in both places*.]