United Nations A/CN.9/637/Add.2

General Assembly

Distr.: General
24 September 2007

Original: English

United Nations Commission on International Trade Law
Fortieth session, second part
Vienna, 10-14 December 2007

Security interests

Draft legislative guide on secured transactions

Note by the Secretariat

Addendum

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V.07-87006 (E) 021007 021007

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A. General remarks

1. Introduction

1. As is the case with respect to any other agreement, issues such as the formation, interpretation, effects, breach and avoidance of a security agreement are subject to general contract law. In addition, as it sets out the bargain between the grantor and the secured creditor, a security agreement is normally subject to special rules regulating security agreements. This usually means, in particular, that a security agreement will be effective between the parties even if it is not effective against third parties.

2. The substantive content of a security agreement will vary according to the needs and wishes of the parties. Typically, clauses in security agreements address three main themes. First, some provisions are included in the agreement because they form part of the mandatory requirements for creating a security right. For example, rules relating to the identification of the encumbered assets and the secured obligation might fall into this category (for the definitions of "encumbered asset" and "secured obligation", see Introduction, section B, Terminology). In chapter IV (Creation of a security right (effectiveness as between the parties)), the Guide recommends that the formal requirements for creating a security agreement that is effective between the parties should be minimal and easy to satisfy (see recommendations 12-14).

3. Second, the typical security agreement will also contain several terms specifying the rights and obligations of the parties once the agreement has become effective between them. Many of these terms deal with the consequences of a default by the grantor or the breach of an obligation by the secured creditor. Often the events constituting a default by the grantor and the remedies available to the secured creditor to enforce the terms of the security agreement are enumerated at length. The significant impact that enforcement may have on the rights of third parties usually has led States to specify in some detail a series of mandatory rules governing default and enforcement (see chapter X, Enforcement). These mandatory rules usually are meant to protect the rights of grantors and third parties. As mandatory rules, they will necessarily override any terms of the security agreement that specify conflicting creditor rights and remedies, unless they are waived by the grantor after default (see recommendation 129) or by the secured creditor at any time (see recommendation 130). Where there is no conflict, however, the terms set out in the security agreement will govern the post-default relationship between the parties.

4. Third, security agreements usually contain a series of provisions meant to regulate aspects of the relationship between the parties after creation but prior to default. Efficiency and predictability in secured transactions often call for additional detailed clauses to govern ongoing aspects of the transaction. Many States actively encourage the parties to fashion the terms of the security agreement to meet their own requirements. Nonetheless, as in the case of post-default rights and obligations, these same States also frame various mandatory rules relating to pre-default rights and obligations (especially when third-party rights may be affected). This said, in

order to offer grantors and secured creditors maximum flexibility to tailor-make their agreement, States usually keep these mandatory pre-default rules to a minimum.

5. While States are generally reluctant to impose a full menu of mandatory rules governing the pre-default rights and obligations, they do have an interest in providing guidance to grantors and secured creditors. Indeed, many States enact a greater or lesser number of non-mandatory (or suppletive) rules that are applicable if the parties do not specify otherwise in their security agreement. This chapter does not address all the situations where States may wish to elaborate such non-mandatory rules. Rather, it offers only an indicative and non-exhaustive list of those suppletive pre-default rules that are commonly found in contemporary national legislation.

6. The discussion that follows focuses on three policy issues. The first, examined in section A.2, relates to the principle of party autonomy and the extent to which 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, explored in section A.3, relates to the mandatory rules that should govern pre-default rights and obligations of grantors and secured creditors. The third, which is the subject of sections A.4 and A.5, concerns the type of non-mandatory rules that could be included in modern secured transactions legislation.

7. Section B of this chapter considers various mandatory and non-mandatory rules to deal with pre-default rights and obligations in relation to particular types of asset and transaction. The chapter concludes, in section C, with a series of recommendations.

2. Party autonomy

(a) General

8. In chapter II (Scope of application and other general rules), the Guide announces the principle of party autonomy as one of the foundations of its basic approach (see recommendation 8). In most States, this principle forms part of the general law of contracts and it is applicable to secured transactions law simply because a security agreement is a contract. The central idea is that, unless a State provides otherwise, the secured creditor and the grantor should be free to craft their security agreement as they see fit. While party autonomy gives credit providers significant power in determining the content of the security agreement, the expectation is that permitting the secured creditor and the grantor to structure their transaction and allocate pre-default rights and obligations as best suited to their objectives will normally permit grantors to gain wider access to secured credit.

9. The party autonomy principle has two distinct dimensions when applied to pre-default rights and obligations. The first is aimed at States. While States should be free to enact mandatory rules to govern key features of the ongoing relationship between parties, their number should be limited and their scope clearly stated. The second is directed to the effects that the grantor and the secured creditor seek to achieve through their agreement. Any terms that derogate from or modify non-mandatory rules or that speak to issues not addressed by a State's suppletive rules,

only bind the parties themselves and, except to the extent provided by general principles of contract law, do not affect the rights of third parties.

10. Legislative limitations on party autonomy in the form of mandatory rules can be found both within a secured transactions law and in other laws. So, for example, many States extensively regulate consumer transactions, often strictly constraining the capacity of secured creditors and grantors to design their own regime of pre-default rights and obligations. An example would be a rule that prohibits secured creditors from limiting the right of consumer grantors to sell or dispose of the encumbered assets. Likewise, many States restrict party autonomy where "family property" or "community property" is at issue. An example would be a rule that prevents secured creditors from limiting the use to which grantors may put such "family property" (see recommendation 2, subparagraph (b)).

11. In addition to these mandatory rules that govern particular grantors and particular assets, it is common for States to impose various mandatory rules of a more general character. These are usually found within the legislation that creates the secured transactions regime. As noted, they most often relate to default and enforcement (for example, the standard of conduct in the case of enforcement cannot be waived unilaterally or by agreement; see recommendation 128). But some also concern pre-default rights and obligations (for example, the party in possession has to take reasonable care of the encumbered assets, as well as to return them and terminate any registered notice upon full payment of the secured obligation; see recommendation 107). These latter types of mandatory rules are discussed in the next section of this chapter.

12. Because party autonomy is the basic principle, the secured creditor and the grantor will typically set out in detail in the security agreement a number of structural elements of their agreement. At least six pre-default dimensions of the agreement are frequently specified by the grantor and the secured creditor:

(a) The assets to be encumbered and the conditions under which assets not initially encumbered may later become encumbered;

(b) The obligation to be secured under the agreement (including future obligations);

(c) What the grantor can and cannot do with the encumbered assets (including the right to use, transform, collect fruits and revenues from, and dispose of, the assets);

(d) When and how the creditor may obtain possession of the encumbered assets prior to default, and the rights and duties of the creditor with respect to those encumbered assets in its possession;

(e) A series of representations and warranties made, and obligations undertaken, by the grantor; and

(f) The events triggering default (primarily of the grantor, but also of the secured creditor) under the agreement.

13. It is against this background of party autonomy and its usual scope as set out in the security agreement that the various mandatory and non-mandatory rules outlined below should be read.

(b) Source of rights and obligations of the parties

14. As already noted, most of the mandatory and non-mandatory rules pertaining to the pre-default rights and obligations of parties relate to the manner in which the prerogatives and responsibilities of ownership are allocated between the grantor and the secured creditor. Consistent with the principle of party autonomy and subject to any appropriate limitations (see paras. 9-11 above), most States take the position that the parties themselves should determine their mutual pre-default rights and obligations. Hence, it is important to determine the source of these rights and obligations.

15. In principle, these rights and obligations are determined by the specific terms and conditions that the parties have included in their agreement. This would also include any general conditions that the parties incorporate into their agreement by reference. In addition, the national law of most States provides that, because the security agreement may refer to an ongoing relationship between the parties that is common in a particular industry or field, they should be bound by any usages to which they have agreed. Finally, unless the parties agree otherwise, in performing their agreement, they should be bound by any practices they have established between themselves. The Guide adopts the idea that the agreement between the parties is the primary source of their mutual rights and obligations, along with any usages to which they have agreed and, absent a contrary agreement, their own established practices (see recommendation 106).

3. Mandatory pre-default rules

(a) General

16. Mandatory rules relating to pre-default rights and obligations of the parties may be found both in secured transactions law and in other laws. Generally these rules are of three broad types. One type, which States usually enact in consumer protection or family property legislation, have a very particular scope and application. The Guide recognizes the importance that States may attach to these matters (see recommendation 2, subparagraph (b)). In order to achieve the maximum economic benefit from a secured transactions regime however, States should clearly specify the scope of these limitations on the parties' freedom to tailor pre-default rights and obligations to their needs and wishes.

17. Other pre-default mandatory rules focus on the substantive content that parties may include in their agreement. Usually these rules are conceived as general limitations on the rights of secured creditors and are applicable whether the grantor is a consumer or an enterprise. They can vary widely from State to State. For example, some States have a carve-out for unsecured creditors in the insolvency context, which tends to be quite restricted. Some States do not permit creditors to restrict the right of a grantor to use or transform the encumbered assets as long as the use or transformation being undertaken is consistent with the nature and purpose of those assets. Some States do not permit a secured creditor either to use or to apply against the secured obligation the fruits and revenues generated by encumbered assets in its possession.

18. Because of the importance that the Guide attaches to the principle of party autonomy, it takes the position that States generally ought not to enact pre-default mandatory rules that restrict the number or nature of the obligations that secured

creditors and grantors may require of each other. Still, the above concerns are often real and, depending on the particular character of their national economy or the commercial enterprise granting the security right, States may feel the need to more closely regulate the pre-default relationship between secured creditors and grantors. Should they do so, however, such mandatory rules should: (a) be expressed in clear language; (b) be drafted in precise and limitative, rather than open-ended, terms; and (c) like similar rules in the post-default context, be based on recognized grounds of public policy (*ordre public*) such as good faith, fair dealing and commercial reasonableness (see recommendations 127 and 128).

19. A third type of pre-default mandatory rule aims at ensuring that the fundamental purposes of a secured transactions regime are not distorted. Typically, States deploy mandatory rules of this type to impose minimum duties upon the party that has possession or control of the encumbered assets. So, for example, since the purpose of security is to provide a creditor with a priority right, upon default, to payment of money generated by the sale of encumbered assets, it would be consistent with this purpose that grantors be obligated not to waste or otherwise allow the encumbered assets to deteriorate beyond what would be expected from normal usage, thereby preserving the economic value of the assets for the benefit of the secured creditors.

20. Rules requiring the grantor and, in the case where the secured creditor has possession, the secured creditor to take reasonable care of the encumbered assets, and more generally rules directed to preserving the encumbered assets, are meant to encourage responsible behaviour by parties to a security agreement. These types of mandatory rules are not, however, identical in impact to consumer-protection rules or mandatory rules stipulating the substantive content of a security agreement. The latter types of mandatory rule are constitutive of the security right itself and cannot be waived either at the time the agreement is negotiated or afterwards.

21. Similarly, parties may not, by agreement, derogate from mandatory rules setting out their general pre-default rights and obligations. For example, States typically do not permit parties to contract out of their duty to take reasonable care of the encumbered assets. However, this does not always disable parties from waiving a breach of the duty after the fact. Many States provide that the secured creditor may later release the grantor from its pre-default obligations (including obligations imposed by mandatory rules) or may waive any breaches by the grantor. By contrast, given the usual dynamic between secured creditor and grantor, many of these same States take the position that the grantor should not be allowed to release the secured creditor, prior to default, from any duties imposed on it by mandatory rules.

22. The mandatory pre-default rules recommended in the Guide aim at policy objectives consistent with what have been defined as the core principles of an effective and efficient regime of secured transactions (see recommendation 1). They set out pre-default rights and obligations that (a) encourage parties in possession to preserve the encumbered assets; and (b) ensure that once the obligation is paid, the grantor recovers the full use and enjoyment of the previously encumbered assets.

23. Chapter XI (Acquisition financing) of the Guide contemplates that some States might choose to preserve retention-of-title and financial lease transactions as independent techniques of acquisition financing. In these situations, the seller's or

lessor's right is not a security right but rather comprises the seller's right to assert its ownership of the assets – in the case of a sale until full payment of the purchase price, and in the case of a financial lease for the duration of the transaction (for the definitions of the terms "security right", "acquisition security right", "retention of title right" and "financial lease right", see Introduction, section B, Terminology). For this reason, even though the fundamental economic objectives of these transactions are identical to those of an ordinary acquisition security right, the mandatory rules concerning pre-default rights and obligations of the parties (the seller that retains ownership and the buyer that has possession but only an expectancy of ownership; the lessor that is owner and the lessee that merely has a right of possession and use) will have to be framed in slightly different language. These necessary adjustments are discussed in chapter XI, section A.8.

(b) Duty to preserve the encumbered assets

24. The encumbered asset is one of the creditor's principal assurances of repayment of the secured obligation. It is also an asset that the grantor normally expects and intends to continue using freely once the loan or credit has been repaid. For these reasons both secured creditors and grantors have an interest in preserving the encumbered asset.

25. Most often the person that has possession of an encumbered asset will be in the best position to ensure its preservation. This explains why States normally impose the duty to take reasonable care of the encumbered asset on that party. Only by exception, and almost invariably in relation to intangible assets, might a person not in notional possession be optimally positioned to care for the encumbered asset. In view of the objective of ensuring a fair allocation of responsibility for caring for encumbered assets and encouraging parties to preserve them it matters little whether it is the grantor or the secured creditor that has possession. The mandatory duties imposed on the person in possession to preserve the encumbered asset should be identical in both cases.

26. The specific content of the duty may vary considerably, depending on the nature of the encumbered asset. In the case of tangible assets, the duty points first to the physical preservation of the asset (for the definitions of the terms "tangible asset" and "intangible asset", see Introduction, section B, Terminology). Where inanimate tangible assets are concerned, this usually would include a duty to keep these assets in a good state of repair and not to use them for a purpose other than that which is normal in the circumstances. For example, if the encumbered asset is a piece of machinery, it must not be left out in the rain. Moreover, the party that possesses and uses it must perform routine maintenance. Still again, if security is taken, for example, on a passenger automobile, the person in possession, who is authorized to use it, cannot then use the vehicle as a light truck for commercial purposes.

27. Where the encumbered assets are inventory the duty of preservation may require other, more onerous, actions on the part of the person in possession. Unlike equipment, inventory is often on display and is easier to steal. Hence the grantor (who is the party most likely to be in possession) must provide adequate security to forestall "shrinkage", must properly display the inventory to avoid breakage, or store it so as to prevent deterioration. For example, if the inventory consists of expensive electronic equipment, or particularly fragile glassware, it may be

necessary to keep it in locked cases; if it consists of perishable foodstuffs, the person in possession would have to store the encumbered assets in refrigerated units.

28. In the case of living tangible assets such as animals, the duty should be similar. It is not enough simply to keep the animal alive. The person in possession must ensure that the animal is properly fed and is maintained in good health (for example, receives adequate veterinary care). Where the animal requires special services to preserve it in good condition (for example, proper exercise for a race horse, regular milking for a cow), the duty of care extends to providing these services. Finally, as with equipment, the duty also means that the animal cannot be used for abnormal purposes. Thus, a prize bull the value of which lies in stud fees cannot be used as a beast of burden.

29. If the encumbered asset consists of a right to payment of money embodied in a negotiable instrument, the duty will certainly include the physical preservation of the document. In such a case, however, the duty of care will include taking the necessary steps to maintain or preserve the grantor's rights against prior parties bound under the negotiable instrument (such as presenting the instrument, protesting it if required by law, and providing notice of dishonour). It may also be incumbent upon the person in possession of a negotiable instrument to avoid loss of rights on the instrument itself against prior parties by taking steps against persons secondarily liable under the instrument (e.g. guarantors). Where the tangible asset is a negotiable document, here also the person in possession must physically preserve the document. Moreover, should the document be time-limited, the person in possession of the document must present it prior to expiry to claim physical possession of the assets covered by the document.

30. Where the encumbered asset is intangible, it is more difficult to fix the duty to take reasonable care by reference to the person in possession. Frequently, the intangible asset is a simple contractual right to receive payment. The character of the duty of preservation in such cases is discussed below in section B. Where the encumbered asset is a right to payment of funds credited to a bank account, intellectual property or a right to receive the proceeds under an independent undertaking, States typically provide for the respective rights and obligations of parties to the transaction in special legislation regulating that particular form of asset.

31. In determining the extent of the obligation of the person in possession to preserve encumbered assets, States are making a cost-benefit judgement as to how best to ensure a fair allocation of responsibility for their preservation. The main policy issue is to avoid placing an undue burden on the person in possession, especially when the person in possession is the secured creditor and not the grantor. In line with the above considerations, the Guide recommends that States enact a general mandatory pre-default rule imposing a duty on parties in possession to take reasonable care to preserve encumbered assets (see recommendation 107).

(c) Duty to preserve the value of the encumbered assets

32. In many cases, the physical preservation of the encumbered asset will also ensure the maintenance of its value. Sometimes, however, additional steps will be necessary. The special case of intangible assets is discussed below in section A.5. As

for tangible assets, States typically distinguish between the obligations of grantors and the obligations of secured creditors. Since the encumbered asset is the secured creditor's guarantee of payment, grantors are occasionally required to take positive action to maintain the value of encumbered assets over and above the obligation to preserve it physically. For example, grantors may be required to install computer upgrades or return equipment to a dealer for service under a recall order. Once again, in determining the extent of this obligation on grantors, States must weigh the benefits against the burdens they impose.

33. Only rarely do States impose any obligation related to preservation of the value of encumbered assets on secured creditors. The rationale is that if the imposition of an obligation requires secured creditors to assume a burdensome responsibility for closely monitoring encumbered assets, the asset will simply cease to have value as security, to the detriment of the grantor. For example, secured creditors should not be required to take any steps to maintain the market value of a trademark, or to engage in investment analysis to maintain the value of a stock portfolio. In any event, it is always in the grantor's interest that the encumbered asset maintains its value so that parties will normally provide that grantors may indicate to secured creditors in possession the steps to be taken to preserve value in such cases. Any money expended to do so will typically either be paid in advance by the grantor or added to the secured obligation.

34. Because the parties will normally provide for additional duties that aim at the preservation of the value of the encumbered assets in their security agreement, States typically do not enact a mandatory rule that directly imposes such a duty either on grantors or on secured creditors. In line with this general tendency, the Guide does not recommend that States enact a mandatory pre-default rule requiring parties in possession to preserve the pre-default value of encumbered assets.

(d) Duty to return the encumbered assets and to terminate a registered notice

35. The central purpose of a security right is to enhance the likelihood that the secured obligation will be satisfied, either by inducing the grantor to repay the secured obligation or by the application of the value of the encumbered asset to the secured obligation. A security right is not a means of expropriating surplus value from the grantor or a disguised transfer of the encumbered assets to the creditor. Upon satisfaction of the secured obligation, as a matter of law, the security right terminates and the grantor is entitled to possession and full enjoyment of unencumbered ownership of the previously encumbered assets. To implement the grantor's rights, most States enact mandatory rules to regulate the duties of the secured creditor once the secured obligation has been repaid in full and all credit commitments have been terminated. These duties are of two types. Some duties relate to the return of the encumbered assets to the grantor in situations where the secured creditor is in possession of the assets at the time of the satisfaction of the secured obligation; other duties relate to taking steps to enable the grantor to enjoy its rights to the encumbered assets free from any disability arising from the prior existence of the encumbrance.

36. The Guide contemplates that secured creditors may, in most cases, make their rights effective against third parties by taking possession of the encumbered assets (see recommendation 36). In addition, even when creditors achieve third-party effectiveness by registering a notice rather than by taking possession, given the

principle of party autonomy, grantors may nonetheless permit secured creditors to take possession of the encumbered assets. This permission may be given either at the time of creating the security right or at some time thereafter. In the latter case, the grantor need not even be in default under the security agreement. Regardless of how it arises, the secured creditor's possession is grounded in the agreement between the parties and relates to the objectives of that agreement.

37. Since a security right is aimed at ensuring the performance of an obligation, once that performance has occurred, the grantor should be able to recover either possession of the encumbered assets or unimpeded access to them, or both. This explains the formal duty that many States impose on secured creditors to return the encumbered assets to the grantor upon full payment of the secured obligation and termination of all credit commitments. In these States, the burden lies on the creditor to deliver the encumbered assets, and not on the grantor to reclaim them or to take them away. In other States, the secured creditor has no obligation to deliver, but need only permit the grantor to reclaim previously encumbered assets. Where tangible assets are in the hands of a third party that was initially in possession for the account of the grantor, but that upon the creation of the security right was holding on behalf of the secured creditor, many States require the secured creditor to indicate to the person in possession that the secured obligation has been paid and that the possessor is once again holding exclusively for the account of the grantor. A similar duty arises in many States where the secured creditor and a deposit-taking institution have entered into a control agreement (for the definition of the term "control", see Introduction, section B, Terminology). In these States, the secured creditor is usually obliged to specifically inform the depositary that the control agreement is no longer in effect. These various requirements are all intended to implement the grantor's right to enjoy the free use of encumbered assets once the secured obligation has been paid in full and all credit commitments have been terminated.

38. Some States consider that the creditor must also take positive steps to ensure that the grantor is placed in the same position that it occupied prior to the creation of the security right. In the case of intangible assets, this would require sending a notice to any third-party obligor (for example, the debtor of a receivable) indicating that the secured obligation has been paid in full and that the grantor is again entitled to receive payment of the obligation. More generally, some States oblige secured creditors to release the encumbered assets from the security right and, in cases where third-party effectiveness has been achieved by registration, to take steps to cancel the effectiveness of the notice relating to that security right on the record of the relevant registry. So, for example, where registrations are not automatically purged from a registry after a relatively short period of time, many States impose upon creditors a duty to request cancellation of the registration. Similarly, where the security right has been made the subject of a notice on a title certificate, some States oblige the secured creditor to take steps to ensure that the notice is deleted from the title certificate. The unifying theme of these requirements is that the secured creditor should take steps to remove any formal evidence of its previous right that might lead third parties to think that the grantor's assets are still potentially subject to its security right.

39. The mandatory rule recommended in the Guide to govern the relationship of the parties once the secured obligation has been paid broadly reflects the above

considerations. Its primary objective is to make certain that the grantor recovers the full use and enjoyment of the previously encumbered assets and is able to deal effectively with them in transactions involving third parties, free of any disability arising from the no longer extant security right (see recommendations 68 and 108).

4. Non-mandatory pre-default rules

40. In addition to various mandatory rules governing pre-default rights and obligations of the parties, most States have developed a longer or shorter list of non-mandatory rules addressing other pre-default issues. The vocabulary used to identify these non-mandatory rules that are "subject to contrary agreement between the parties" varies from State to State (e.g. *jus dispositivum, lois supplétives, normas supletorias*, suppletive rules, default rules). Their common feature, however, is this: they are meant to apply automatically as additional terms to the security agreement unless there is evidence that the parties intended to exclude or modify them.

41. Different policy rationales are offered to support the idea of non-mandatory rules. Some States use non-mandatory rules to protect weaker parties on the theory that they provide a baseline against which the stronger party may attempt to negotiate an alternative contractual provision. Other States conceive them as rules simply mirroring the terms of an agreement that parties would have negotiated had they turned their attention to particular points. The Guide takes the position that the true justification for non-mandatory rules lies in the fact that they can be used to promote policy objectives consistent with the logic of a regime of secured transactions. Examples of non-mandatory rules grounded in this rationale are not hard to find. The law in many States provides that, unless the parties agree otherwise, the grantor will deposit any insurance proceeds arising from the loss of or damage to the encumbered asset in a deposit account controlled by the secured creditor. Also, the law in many States provides that, unless the parties agree otherwise, revenues deriving from the encumbered asset may be retained by the secured creditor during the life of the security agreement as additional encumbered assets, so that in case of default those revenues may be applied to the payment of the secured obligation. In view of this general objective, there are at least four reasons why States might choose to develop a panoply of non-mandatory rules.

42. First, by allocating rights and obligations between a secured creditor and a grantor in the manner to which they themselves would likely agree, given the basic purposes of a secured transactions regime, a set of non-mandatory rules helps to reduce transaction costs, eliminating the need for the parties to negotiate and draft new provisions already adequately covered by these rules. Here non-mandatory rules serve as implied or default terms (i.e. terms applicable in the absence of agreement to the contrary) that, unless a contrary intention is expressed in the security agreement, are deemed to form part of that agreement. An example of such an implied term would be a rule that permits a secured creditor in possession of the encumbered asset to obtain any revenues produced by that asset and to apply them directly to the payment of the secured obligation.

43. Second, even the best-advised and most experienced parties do not possess infallible insight into the future. However carefully drawn an agreement, there will be unforeseen circumstances. To obviate the need for a judicial or arbitral decision to fill these gaps in the agreement when they arise and to reduce the number of potential disputes, States usually provide for basic characterization rules. These

non-mandatory rules direct parties to other, more general, legal principles that can be deployed to guide the resolution of unanticipated problems. An example of such a rule is that which provides that the grantor of a security right remains the holder of the substantive right (be it ownership, a lesser property right or a personal right) over which security has been taken. Thus, in working through any particular unforeseen event, the parties may begin with the principle that the exercise of any right not specifically allocated to the secured creditor remains vested in the grantor.

44. Third, a relatively comprehensive legislative elaboration of the rights and obligations of the parties before default increases efficiency and predictability by directing the attention of parties to issues that they should consider when negotiating their agreement. A series of default rules from which they may opt out can serve as a drafting aid, offering a checklist of points that might be addressed at the time the security agreement is finalized. Even when parties decide to modify the stated non-mandatory rules so as to better achieve their purposes, the exercise of having attended to them ensures that these matters are considered and not inadvertently left aside.

45. Finally, non-mandatory rules make it possible for the principle of party autonomy to operate most efficiently. This benefit is particularly evident in long-term transactions where the parties cannot anticipate every contingency. Such rules facilitate flexibility and reduce compliance costs. For example, treating the agreement as complete in itself and requiring the parties to formalize all subsequent modifications and amendments to that agreement simply imposes additional transaction costs on the grantor. As these are non-mandatory rules, parties can always exclude their application by a specific contractual provision, such as a clause that provides that a written document contains the entire agreement of the parties and that no oral modifications are permitted.

46. The advantages of permitting the parties to define their relationship with the assistance of a set of non-mandatory rules are widely recognized by many national legal systems (e.g. articles 2736-2742 of the Civil Code of Québec, Canada, and articles 9-207 to 9-210 of the Uniform Commercial Code in the United States), by organizations that promote regional model laws (e.g. article 15 of the European Bank for Reconstruction and Development Model Law on Secured Transactions and article 33 of the Organization of American States Model Inter-American Law on Secured Transactions), and by international conventions dealing with international sales (e.g. United Nations Sales Convention, article 6)[1] or some aspect of secured transactions in movable property (e.g. United Nations Assignment Convention, article 11, paragraph 1, and article 15 of the International Institute for the Unification of Private Law (Unidroit) Convention on International Interests in Mobile Equipment).

5. Typical non-mandatory pre-default rules

(a) General

47. This chapter does not address all of the situations where States may wish to develop non-mandatory rules. For example, it does not deal with any non-mandatory rules that may be developed in relation to additional terms that complete those

[1] United Nations publication, Sales No. E.95.V.12.

required for a security right to exist (e.g. the possible contents of the security agreement above the minimum necessary for creation). Non-mandatory rules in this context fulfil a different function and their desirability, scope and content would, therefore, be governed by different policy considerations. Moreover, and for the same reason, it does not consider non-mandatory rules that are meant to govern post-default rights and obligations of the parties. These non-mandatory rules are addressed in chapter X (Enforcement).

48. The non-mandatory rules discussed in this section are those directed to pre-default rights and obligations of the parties. Because non-mandatory rules will usually reflect the needs, practices and policies of particular States, their specific configuration varies enormously. Still, there is a core of non-mandatory rules that are commonly found in contemporary national legislation. These are typically of two broad types: rules that serve as a complement to mandatory rules dealing with the rights and duties of secured creditors in possession of encumbered assets, and rules that elaborate the rights retained by the grantor regardless of where possession lies.

49. Like mandatory rules, these non-mandatory rules are meant to encourage responsible behaviour on the part of those having control and custody of encumbered assets. Hence, States most often organize them according to whether the secured creditor or the grantor has possession of the encumbered assets. Some non-mandatory pre-default rules, however, are intended to apply regardless of whether the secured creditor or the grantor is in possession. These three situations are considered in turn.

(b) Non-mandatory rules where the secured creditor is in possession

50. As already noted, most States have mandatory rules that require secured creditors in possession to take reasonable care of, to preserve and to maintain the encumbered assets in their possession. Typically, where the secured creditor has a right to use encumbered assets, it is also bound to undertake all necessary repairs to keep them in good working condition. The basic content of these mandatory rules has already been discussed. In addition, some States enact a series of non-mandatory rules that specify further obligations of creditors to care for encumbered assets in their possession, especially in cases where the encumbered asset generates civil and natural fruits, or is otherwise an income-producing asset. The following paragraphs address the more common non-mandatory rules of this type.

51. As for the basic obligation of care and preservation, many States specifically require that the secured creditor keep the encumbered tangible assets clearly identifiable. If these assets are fungible and commingled with other assets of the same nature, this duty is transformed into an obligation to keep a sufficient quantity of assets of the same quality as those originally encumbered. In addition, where maintenance requires action beyond the creditor's personal capacity, States often require the creditor to notify the grantor and, if necessary, permit the grantor temporarily to take possession to repair, care for or preserve the asset or its value.

52. Where the encumbered asset consists of an instrument embodying the grantor's right to the payment of money, the obligation of care on the part of the secured creditor may not be limited to the physical preservation of that document. Many States oblige the secured creditor in possession of a negotiable instrument to

avoid loss of rights on the instrument itself against prior parties by taking steps against persons secondarily liable under the instrument (e.g. guarantors). In these States, it is also common to provide that either the grantor or the secured creditor may sue to enforce the payment obligation.

53. A non-mandatory corollary to the secured creditor's obligation to take care of the encumbered asset is its entitlement to be reimbursed for reasonable costs expended to preserve the asset, and to have these costs added to the secured obligation. In addition, many States permit the secured creditor to make reasonable use of or operate the encumbered asset (see recommendation 109, subparagraph (b)). As concomitants of this right, the secured creditor must allow the grantor to inspect the encumbered asset at all reasonable times and will be liable in damages for any deterioration of the asset beyond that associated with normal use (recommendation 109, subparagraph (c)).

54. Because the secured creditor is in possession, it will most often be in the best position to collect monetary proceeds (revenues or civil fruits) or non-monetary proceeds (natural fruits are also included in the definition of the term "proceeds", see Introduction, section B, Terminology) derived from the encumbered asset. For this reason, it is common for States to enact a non-mandatory rule that both monetary and non-monetary proceeds are to be collected by the secured creditor in possession. Normally, it is the grantor that will be able to get the best price for the natural fruits generated by encumbered assets (for example, milk produced by a herd of cows, eggs produced by chickens, wool produced by sheep). Therefore, States usually also provide that, in the rare case where the secured creditor takes possession of livestock, it should turn the fruits over to the grantor for disposition. Where the fruits involve the natural increase of animals, a common non-mandatory rule is that such offspring are automatically encumbered by the security and held by the creditor under the same terms as the parent.

55. Where the proceeds are monetary, it often makes little sense to oblige the creditor, after collection, to turn these over to the grantor. The usual non-mandatory rule is that the secured creditor may either apply cash proceeds to repayment of the secured obligation, or hold them in a separate account as additional security. This principle operates whether the money received is interest, a blended payment of interest and capital, or a stock dividend. Some States even give the creditor the choice of selling additional stock received as a dividend (accounting for the proceeds of sale as if they were cash dividends), or to hold this stock (in the manner of the offspring of animals) as additional encumbered assets. However, it is also common for the secured creditor and the grantor to agree in the security agreement that, so long as the grantor is not in default under the security agreement, dividends (whether in the form of cash or stock) may be retained by the grantor.

56. There is great diversity in the non-mandatory rules governing the secured creditor's right to dispose of encumbered assets in its possession. Some States provide that the secured creditor may assign the secured obligation and the security right. That is, the creditor may actually transfer possession of the encumbered asset to a person to whom it has assigned the secured obligation. Some States also provide that the secured creditor may create a security right in the encumbered asset as security for its own debt ("re-pledge the encumbered assets") as long as the grantor's right to obtain the assets upon payment of the secured obligation is not impaired. Often these re-pledge agreements are limited to stocks, bonds and other

instruments held in a securities account, but in some States creditors may re-pledge tangible assets such as diamonds, precious metals and works of art. By contrast, many States prohibit the secured creditor in possession from re-pledging the encumbered assets, even if it can do so on terms that do not impair the grantor's right to recover its assets upon performance of the secured obligation.

57. The risk of loss or deterioration of assets normally follows ownership, not possession. Nonetheless, many States provide that, where encumbered assets in the possession of the secured creditor are destroyed or suffer abnormal deterioration, the secured creditor is presumed to be at fault and must make good the loss. Typically, however, the same non-mandatory rule provides that the creditor is not liable if it can show that the loss or deterioration occurred without its fault. Because it will always be in the secured creditor's interest to ensure that the value of the encumbered assets is maintained, many States provide that the creditor has an insurable interest. Should the secured creditor then insure against loss or damage, however caused, it is entitled to add the cost of the insurance to the obligation secured.

58. This last rule is a particular example of a broader principle enacted as a non-mandatory rule in many States and recommended by the Guide. Reasonable expenses incurred by the secured creditor while discharging its custodial obligation to take reasonable care of the encumbered assets are chargeable to the grantor and automatically added to the obligation secured (see recommendation 109, subparagraph (a)). Tax payments, repairer's bills, storage charges and insurance premiums are examples of such reasonable expenses for which the grantor is ultimately liable.

(c) Non-mandatory rules where the grantor is in possession

59. A key policy objective of an efficient and effective secured transactions regime is to encourage responsible behaviour by a grantor that remains in possession of the encumbered assets. Avoiding actions that decrease the value of the encumbered assets beyond depreciation by normal usage is consistent with this objective. Hence, most States impose on the grantor in possession the same obligation of care and preservation as that resting upon secured creditors in possession. The grantor's duty to take care includes keeping the encumbered assets properly insured and paying taxes promptly. If the secured creditor incurs these expenses, even though the grantor remains in possession, the secured creditor has the right to reimbursement from the grantor and may add these expenses to the secured obligation.

60. In addition to these mandatory rules, however, many States enact non-mandatory rules for grantor-in-possession security aimed at maximizing the economic potential of the encumbered assets. In particular, encouraging the grantor's use and exploitation of encumbered assets is seen as a way to facilitate revenue generation and repayment of the secured obligation. For this reason, States often provide that, unless otherwise agreed, the grantor in possession does not surrender the general prerogatives of ownership (the right to use and enjoy, the right to appropriate fruits, and the right to dispose) simply because a security right has been created. This means that, in the normal situation, the grantor is entitled to use, lease, process and commingle the encumbered assets with other assets in a manner that is reasonable and consistent with its nature and purpose and the parties'

objectives as set out in the security agreement. In such cases, the secured creditor should have the right to monitor the conditions in which the encumbered asset is kept, used and processed by the grantor in possession and to inspect the asset at all reasonable times (see recommendation 108, subparagraph (c)).

61. If the encumbered assets consist of income-producing assets in possession of the grantor, to the extent that the creditor's 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. Specific obligations of the grantor in the case of intangible assets (e.g. rights to payment of funds credited to a bank account, royalties from the licensing of patents, copyrights and trademarks), and particularly the grantor's right to payment in the form of receivables, are discussed in the next section.

62. Many States currently have a non-mandatory rule that protects fruits and revenues (as opposed to proceeds of disposition in the strict sense) from automatic re-encumbering under the security agreement. The policy objective is to provide the grantor with the chance to gain additional financing by isolating these new assets from the existing security. Other States set the default rule so as to automatically encumber fruits and revenues under the initial security right. The policy objective here is that the parties would normally expect and intend fruits and revenues to be encumbered, and that the non-mandatory rule should reflect these normal expectations. In any event, because this is invariably enacted as a suppletive rule, should the parties wish to exclude fruits and revenues, either at the time of negotiating the security or at any time thereafter, they may freely do so.

63. The Guide provides in chapter IV on creation (see recommendation 18) that a security right extends to all proceeds generated by the encumbered asset. That is, unless otherwise agreed, any assets derived from the encumbered assets in the grantor's possession is automatically subject to the security right, regardless of whether those additional assets are regarded as civil or natural fruits or as proceeds (in the strict sense). To the extent that the fruits are in kind (e.g. increase in animals, stock dividends), the grantor may use and exploit them under the same terms and conditions as initially encumbered assets. Where they are agricultural products like milk, eggs and wool, most States provide that the grantor may sell them and that the secured creditor's rights extend to the proceeds received upon their disposition. Where the civil fruits are revenues (e.g. rentals received from the lease of property, interest received upon the loan of money), the security right will extend to them as long as they remain identifiable. As a rule, however, the grantor in possession will not only collect fruits and revenues, it will also dispose of the fruits in the ordinary course of business free of the security right (presumably generating proceeds that will become encumbered assets.

64. The duty to preserve the encumbered asset normally means that the grantor in possession is liable for loss or deterioration, whether caused by its fault or by fortuitous event. This means that, by contrast with a secured creditor in possession, who is not liable to the grantor for loss or deterioration caused by a fortuitous event, the grantor is liable however the loss arises, and would be, consequently, in default under the agreement.

65. In principle, the grantor is not entitled to dispose of the encumbered assets without authorization of the secured creditor. If the grantor does so, the buyer will take the assets subject to the security right (see recommendation 75). By way of exception, however, the grantor may dispose of the encumbered assets free of the security right if they consist of inventory or consumer goods and they are sold in the seller's ordinary course of business (see recommendation 77). Despite this limitation on disposition, because the grantor will normally retain the full use of the encumbered asset, most States enact non-mandatory rules authorizing the grantor to create additional security rights charging already encumbered assets, the fruits and revenues they generate and the proceeds of their disposition. The Guide's recommendations are consistent with this approach. Moreover, the grantor's lack of authority to grant additional security rights does not prevent their successful creation, even though doing so may constitute a default under the security agreement.

(d) Non-mandatory rules regardless of who is in possession

66. In addition to the rights specifically given to, and obligations specifically imposed on, secured creditors and grantors because of their possession of the encumbered assets, many States also enact non-mandatory rules that speak to both secured creditor-in-possession (possessory) and grantor-in-possession (non-possessory) situations. Two such rules, one focusing on the grantor's obligations and the other on the secured creditor's rights, are common.

67. The first rule is a corollary to the idea that a grantor in possession should maintain the value of encumbered assets. If it should happen that the value of the encumbered assets were to decrease significantly, even for reasons unrelated to any lack of attention by the party in possession, some States provide that the grantor will have to offer additional security (or additional assets) to make up for unforeseeable decreases in value. Moreover, this rule is often extended to normal deterioration of the value of the encumbered assets due to wear and tear or market conditions, whenever such deterioration reaches a significant percentage of the initial value of the encumbered assets. Typically, however, parties will provide for top-up provisions in their agreement, and specify in detail the conditions under which the grantor will be required to offer further assets should the value of the encumbered assets fall precipitously.

68. A second common non-mandatory rule concerns the right of the secured creditor to assign both the obligation secured and the security right that relates to it. Absent agreement to the contrary, a secured creditor may freely assign the secured obligation and the accompanying security right (see, for example, United Nations Assignment Convention, article 10, and recommendation 24). Some States even provide that the secured creditor may do so even despite contractual limitations on assignment (see United Nations Assignment Convention, article 9, paragraph 1, and recommendation 23). Where the secured creditor has possession of the encumbered asset, this implies that it may also transfer possession to the new secured creditor. In both cases, however, absent a specific agreement to the contrary between the grantor and the original secured creditor (the assignor) authorizing such an arrangement, the assignee of the secured obligation cannot acquire greater rights as against the grantor, or assert greater prerogatives in relation to the encumbered asset, than those that could be claimed by the assignor.

B. Asset-specific remarks

69. The mandatory and non-mandatory rules pertaining to the pre-default rights and obligations of parties relate to the manner in which the prerogatives and responsibilities of ownership are allocated between the grantor and the secured creditor. These include, most importantly: (a) the obligation (invariably imposed upon the party in possession of the encumbered assets) to care for, maintain and preserve it; (b) the right to use, transform, mix and manufacture encumbered assets; (c) the right to collect fruits, revenues and proceeds generated by the assets and to appropriate these to one's use; and, in some States, (d) whether the secured creditor has the right to pledge, re-pledge or dispose of encumbered assets, whether free of, or subject to, the security right.

70. These rules generally contemplate situations involving tangible assets. Nonetheless, in chapter III (Basic approaches to security) the Guide notes the importance of intangible assets and, in particular, rights to payment as assets that a grantor might encumber. While certain categories of intangible asset are excluded from the Guide (e.g. securities and payment rights under financing contracts; see recommendation 4, subparagraphs (c) and (d)), many other types of intangible asset are included: notably, contractual and non-contractual receivables, rights to payment of funds credited to a bank account and rights to receive the proceeds under an independent undertaking (see recommendation 2, subparagraph (a)).

71. The creation of a security right in a right to payment necessarily involves parties other than the grantor and the secured creditor, most obviously the debtor of the receivable. Because the encumbered asset is the obligation owed to the grantor by a third person, States have been required to develop detailed rules to regulate the triangular relationship among the parties and also between them and third parties. These rules address the rights and obligations of the parties and of third parties, whether the right to payment arises under a tangible asset (e.g. a negotiable instrument or a negotiable document) or under an intangible asset (e.g. a receivable, rights to payment of funds credited to a bank account, proceeds under an independent undertaking). Most of the rules relating to the relationship between the grantor and the secured creditor on the one hand, and the debtor on the obligation (what the Guide calls third-party obligors) on the other, are mandatory but some are non-mandatory. The rights and obligations of third-party obligors are discussed in detail in chapter IX.

72. This section focuses on the pre-default rights and obligations as between the assignor (the grantor) and the assignee (the secured creditor) (for the definition of the terms "assignor" and "assignee", see Introduction, section B, Terminology). As in the case of tangible assets, most States take the position that the parties themselves should determine their mutual pre-default rights and obligations (see recommendation 106). Hence, the majority of the rules relating to these rights and obligations are non-mandatory. Nonetheless, because of the impact these rules may have on third parties, States often adopt a mixture of mandatory and non-mandatory rules. Articles 11-14 of the United Nations Assignment Convention provide a good example of this practice in the case of international assignments of receivables.

73. Some of the most important parts of the agreement between the assignor and the assignee relate to the representations that the assignor makes to the assignee. In

the normal case, it is presumed that (a) the assignor has the right to assign the receivable; (b) the receivable has not been previously assigned; and (c) the debtor of the receivable does not have any defences or rights of set-off that can be set up against the assignor. In other words, if the assignor has doubts about any of these matters, it must explicitly mention them in the agreement or must explicitly state that it makes no representations to the secured creditor about them. In all events, in parallel with the grantor's pre-default obligations in respect of tangible assets, the assignor must take all reasonable steps necessary to preserve its legal right to collect on the receivable. On the other hand, unless the assignor specifically warrants otherwise, it is presumed that the assignor does not warrant the actual capacity of the debtor of the receivable to pay. These various obligations are presented in the form of non-mandatory rules in the national law of most States and are recommended as such in the Guide (see recommendation 110).

74. As the value of the assigned receivable consists of payment made by the debtor of the receivable, and as that debtor is only obliged to pay the assignee if it actually knows of the assignee's rights (see recommendations 114 and 115), it is important to maximize the capacity of the assignee to make the debtor aware of the assignment. For this reason, most States provide that either the assignor or the assignee may notify the debtor and give instructions about how payment is to be made. Nonetheless, in order to prevent conflicting instructions from being given, these States normally also provide that, once notice of the assignment has been given, only the assignee may direct the debtor as to the manner and place of payment. The Guide also adopts this well-established framework for notifying the debtor of the receivable (see recommendation 111).

75. There may, of course, be situations where both the assignor and the assignee (or just one of them) do not wish the debtor of the receivable to know of the assignment. This desire may relate to particular features of the grantor's business or to general economic conditions. For this reason, States usually provide that the assignor and assignee may agree to postpone notifying the debtor of the receivable that the assignment has occurred until some later time. Until such notice is given, the debtor of the receivable will continue to pay the assignor according to the original agreement between them or any subsequent payment instructions. Where a party (usually the assignee) is in breach of an obligation not to notify, this should not prejudice the debtor of the receivable. The debtor will thereafter be required to pay according to the instructions given and is entitled to receive a discharge for amounts so paid (see recommendation 115). Nonetheless, many States also provide that, unless the assignor and assignee otherwise agree, such a breach of the obligation not to give notice may give rise to liability for any resulting damages. The Guide recommends that these general principles govern notification of the assignment to the debtor of the receivable (see recommendation 111).

76. Because the right to payment is the actual object of the security, it is important to specify the effect of any payment made by the debtor of the receivable (whether to the assignor or the assignee) on the respective rights of assignor and assignee. Many States have enacted non-mandatory rules to govern payments made in good faith that may not actually be made according to the intention of the assignor or assignee. This can sometimes occur because the debtor of the receivable has received conflicting payment instructions, or learns of the assignment without actually having received formal notice of it.

77. There are two standard situations that these rules typically address. First, even if no notification of the assignment is given to the debtor of the receivable, payment might actually be made to, or received by, the assignee. Given the purpose of the security right in the receivable, it is more efficient that the assignee be entitled to keep the payment, applying it to a reduction of the assignor's obligation. Similarly, if payment is made to the assignor after the assignment has been made, and again regardless of whether the debtor of the receivable has received notice, the assignor should be required to remit the payment received to the assignee. Likewise, once notice has been given, if part of the payment obligation is to return certain tangible assets to the assignor, States often provide that these assets should be handed over to the assignee. For example, if part of the payment obligation of the debtor of the receivable is meant to transfer a negotiable instrument to the assignor, once notice is received that negotiable instrument should be transferred to the assignee. Adoption of this set of practices to govern mis-directed payments is recommended in the Guide (see recommendation 112, subparagraph (a)). In all these cases, of course, the rules adopted by many States are non-mandatory and, as a result, the assignor and assignee might provide for a different outcome in their agreement.

78. In the case of multiple assignments of a receivable, the debtor of the receivable may receive multiple notifications and may be uncertain as to which assignee has the best right to payment. Sometimes, the payment is made in good faith to an assignee that has a lower priority. In such cases, States usually provide that the assignee with prior rank should not be deprived of its rights to obtain payment, and where the payment obligation involves the return of assets to the assignor, its right to receive these assets as well. The assignee with lower priority must remit the payment of the assets to the assignee with higher priority. Consistent with its general approach to allocating pre-default rights and obligations as between assignor and assignee, the Guide recommends that these general principles govern cases where payment has been made in good faith to a person not actually entitled to receive it (see recommendation 112, subparagraph (a)).

79. Whatever the circumstances under which the assignee obtains payment, States invariably provide, by means of a mandatory rule, that the assignee may only retain the payment to the extent of its rights in the receivable. In other words, unlike the case of ordinary post-default enforcement (see chapter X, Enforcement), if the payment made by the debtor of the receivable is greater than the outstanding indebtedness of the assignor, the assignee may not keep the surplus (see recommendation 151). The assignee must remit the excess to the person who is entitled to it (the next lower-ranking assignee or the assignor, as the case may be). In the same manner that a secured creditor that has been fully satisfied must either remit tangible assets to the grantor or ensure that notice of its rights is expunged from the general security rights register, States usually also require an assignee that has been fully satisfied to notify the debtor of the receivable of that fact, and that it should no longer receive payment. This is the position recommended in the Guide (see recommendation 112, subparagraph (b)).

80. These mandatory and non-mandatory rules relating to pre-default rights and obligations of assignors and assignees of intangible assets help to structure the relationship between them. In many ways, the non-mandatory rules reflect what suppletive rules are meant to accomplish, which is why they are explicitly stated in the national law of many States. For this reason also, the Guide recommends that

they be included in any law relating to secured transactions so as to facilitate the efficient assignment and collection of receivables, while nonetheless permitting assignors and assignees to structure their own transactions differently so as to meet their own needs and wishes.

C. Recommendations

[*Note to the Commission: The Commission may wish to note that, as document A/CN.9/637 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.*]